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A Quarterly Newsletter for Homestead Funds' Shareholders

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Keeping a Lid on Bull Market's Cap Gains

RE Advisers' long-term view can help with tax efficiency

With April 15 behind us, many investors were reportedly startled to see higher tax bills due to unexpectedly large capital gains distributions at year-end.

According to Morningstar's Russ Kinnel, "We've seen the amount of capital gains steadily creep up in recent years, and that figures to continue as long as the stock market rally does. As you get above a turnover of 40 percent in a fund with a potential capital gains exposure above 40 percent, it's a virtual certainty they will make sizeable distributions."

But for investors in Homestead's Value and Small-Company Stock Funds, even though shareholders saw the value of these domestic equity funds increase in 2014, similar large tax liabilities were not triggered. The reason why relates to the investment advisor's long-term, low portfolio turnover approach to investing.

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Homestead's Value and Small-Company Stock Funds are managed first for performance. Tax efficiency, while not an objective, is an attractive by-product of the funds' generally low portfolio turnover. Of course, just as trading activity changes over time, capital gains distributions will vary also.

On Bulls, Bubbles and Bears

Following the bull market's six-year anniversary over the March 10 weekend, many analysts and investors grew thoughtful over just about how much longer the bulls have to run.

Stephen Kaszynski, CFA
Director, President and CEO

No one knows, of course, when stock prices might correct. And trying to time one's exit and return to any asset class is extremely risky.

Since 1926, the stock market has been through 19 bear markets, with one on average nearly every five years. A bear market is one in which major stock market indices decline by at least 20 percent for more than two months.

Valuations and Outlook

At RE Advisers, Homestead Funds' investment advisor, we are of the view that U.S. stocks still look attractive. Forward price-earnings ratios are high but not extreme. However, with bond yields near historic lows, U.S. bonds, particularly at long-dated maturities, appear overvalued.

While no investor controls the action of the markets, all investors should be focused on their overall financial objectives and select a mix of investments that appropriately balances their appetite for risk with expectations for return.

Throughout this issue we discuss how Homestead Funds' portfolio managers look to identify long-term value in any market environment. Be sure to also see the page 4 story on inflation. It's been seemingly benign as the economic recovery continues but always a force for investors to reckon with.

ESTABLISHED 1990

Homestead Funds

A Word about Capital Gains Distributions

Capital gains distributions occur when a mutual fund manager liquidates underlying positions that have made gains since they were added to a fund. These distributions are then taxed as capital gains to the account owner.

Mutual funds are required to pass through to shareholders substantially all of the interest income and capital gains earned by the fund during the year. Shareholders may elect to have their portion of fund distributions paid in cash or reinvested in their account.

Capital gains distributions are not taxable to investors who hold shares in tax-sheltered arrangements, such as IRAs. Instead, the distributions are reinvested in the account. Depending on the type of IRA and other factors, withdrawals from these accounts may be subject to taxes.

Taxes and Transaction Costs Diminish Returns

The table below shows the highest and lowest annual portfolio turnover rates for Homestead's Value and Small-Company Stock Funds since the funds' inceptions. Also listed is the Morningstar Tax-Cost Ratio, a measure of how much a fund's annualized return is reduced by the taxes investors pay on distributions.

	Portfolio Turnover Rate		Tax-Cost Ratio*		
	Lowest	Highest	1 Year	5 Year	10 Year
Value Fund	2% 1993 2012 2013 2014	29% 2002	0.74%	0.59%	0.73%
Small-Company Stock Fund	1% 2012 2013	26% 2008	0.55%	0.22%	0.38%

*Source: Morningstar as of 5/31/2015. Like an expense ratio, the tax-cost ratio is a measure of how one factor can negatively impact performance. Also like an expense ratio, it is usually concentrated in the range of 0-5%. 0% indicates that the fund had no taxable distributions and 5% indicates that the fund was less tax efficient.

Limiting Friction on the Road to Wealth Creation

Portfolio managers for Homestead's Value and Small-Company Stock Funds actively trade securities with a goal of generating long-term performance above the funds' benchmark indices. The level of trading activity varies based on the portfolio managers' views of opportunities and other factors, but the portfolios are not aggressively traded.

The portfolio turnover rate — the percentage of a fund's holdings that have changed over a year — is a measure of a fund's trading activity. The rate is calculated by dividing the lesser of purchases or sales (excluding those of short-term assets) in a fund's portfolio by average net assets. In 2014, the Value and Small-Company Stock Funds had average annual portfolio turnover rates of 2 percent and 3 percent, respectively. The Investment Company Institute, a trade association representing mutual fund companies, calculates that in 2014 the asset-weighted average annual turnover rate experienced by equity fund investors was 43 percent.

These Homestead Funds portfolio managers take a long-term view and, unless their investment thesis changes, tend to stand by their selections. This more moderate approach to equity investing has a two-fold advantage:

1. Fewer trades lowers commissions and fees — and reduces expenses to shareholders.
2. Our turnover rate, which is substantially below the industry average, helps reduce the frequency and size of realized capital gains.

Certainly, tax implications should not be the only factor in your investment decision-making, but being aware of how a fund's management approach is likely to impact your returns can help you stay on track to meeting your financial objectives.

The Enduring Appeal of Homestead Value Fund: 1990 to 2014

In anticipation of Homestead Value Fund's 25th anniversary this fall, we thought it would be worthwhile to take a look back at the fund's track record and some of the events that shaped our nation's economic growth and history.

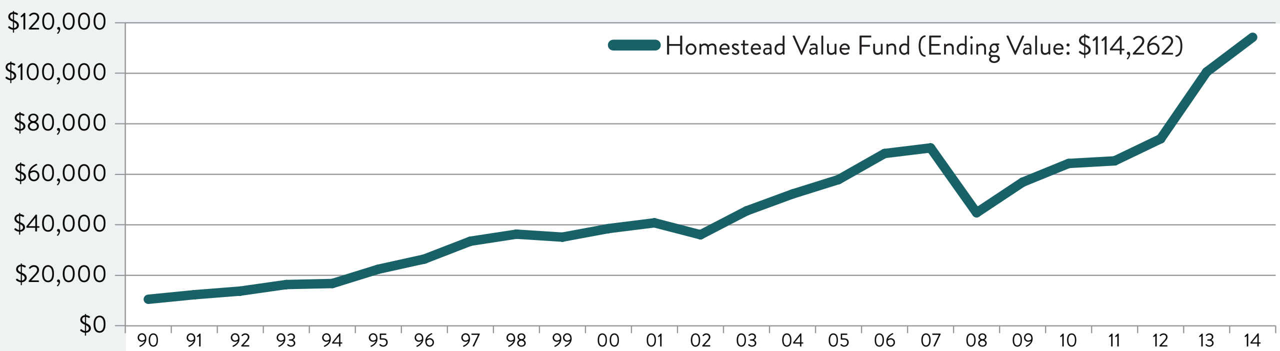
It was November 19, 1990, and the first Gulf War was getting underway. Digital cameras were new to the marketplace, season one of *The Simpsons* had just concluded and the Homestead Value Fund (HOVLX) was launched.

Since that day, the fund has grown through the ups and down of changing markets over nearly 25 tumultuous years of American history. Against a backdrop of warfare, technological advances and two major stock market corrections, Homestead Value Fund has continued to pursue long-term capital growth and, secondarily, income for its shareholders.

How $10,000 in Homestead's Value Fund Grew to $114,262

Look at almost any of these headline news stories from the past 25 years and you'd have a reason not to invest. But those who did and stayed the course were rewarded. This chart shows the change in value of a $10,000 investment made at the fund's inception in 1990 through year-end 2014, assuming all dividends were reinvested. ✸

Ten Thousand Dollars Invested in Value Fund at Launch



1990 – 1994

- Drexel Burnham Lambert files for Chapter 11
- Iraq invades Kuwait
- NAFTA is passed
- Federal funds rate increases for the first time in 5 years to 3.25%
- Orange County, CA, files for bankruptcy protection following huge investment losses

1995 – 1999

- Fed funds rate peaks at 6%
- In 1995, DJIA closes above 4,000 for the first time
- Partial government shutdown
- Asian financial crisis
- Russia defaults
- The Euro is introduced
- DJIA tops 10,000

2000 – 2004

- Dow and NASDAQ experience record losses
- 9-11 World Trade Center and Pentagon bombings
- Enron declares bankruptcy
- WorldCom files for bankruptcy protection
- Operation Iraqi Freedom begins
- Federal funds rate reduced to 1%, the lowest in 45 years
- Hussein captured

2005 – 2009

- Fannie Mae and Freddie Mac are placed under Treasury control
- Lehman, AIG and Bear Stearns collapse
- Goldman Sachs and Morgan Stanley become bank-holding companies
- Fed establishes liquidity facilities for commercial paper issuers
- Federal funds rate cut to 0%
- DJIA drops below 7,000 for the first time since 1997

2010 – Present

- Data shows U.S. recession officially ended in 2009
- PPACA signed into law
- Osama bin Ladin killed
- Foreclosures fall to five-year low
- U.S. debt ceiling crisis, government shutdown
- Stock market rallies to new DJIA and S&P 500 peaks
- Quantitative Easing (QE) ends
- U.S. contends with ISIL

The chart represents past performance, which is no guarantee of future results. Current performance may be higher or lower than that shown above. Returns and the principal value of your investment will fluctuate such that shares, when redeemed, may be worth more or less than their original cost.

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.

Low Inflation, No Worries?

The sooner you take action to control what you can and diversify your portfolio with investments that have the potential to offset inflation, the better off you could be. The good news is you don't have to go through your "inflation fighting" experience alone.

Proceed with Caution

As the U.S. economy moves forward in positive growth territory for its fifth straight year, a number of indicators are pointing to signs of higher inflation. Such factors as rising employment and moderate wage increases may be setting the stage for higher inflation, following the plunge it has taken in the U.S., Germany and Japan.

But the inflation rate as measured by the Consumer Price Index (CPI) is still less than half of its historical average. Why the disconnect?

"CPI is one measure of inflation, but there are others," says Doug Kern, portfolio manager for Homestead's Short-Term Government Securities and Short-Term Bond Funds. "For example, the Federal Reserve frequently comments on the Personal Consumption Expenditures (PCE) Index, a measure of price changes in consumer goods and services."

The generally better known CPI, created by the U.S. Bureau of Labor Statistics (BLS), measures monthly price changes for more than 80,000 consumer goods and services. CPI is a statistical measure of what consumers are paying now relative to what they paid in a prior period. But the marketplace of goods and services is constantly changing, so the BLS, over time, periodically replaces items or makes adjustments with a goal of comparing like products and services.

Inflation Illustrated

Spending Then and Now

Car	House
• 1974: $3,650	• 1974: $37,400
• 1994: $12,750	• 1994: $135,000
• 2014: $31,252	• 2014: $302,000

Earnings Then and Now

Minimum Wage	Median Family Income
• 1974: $2.00	• 1974: $14,747
• 1994: $4.25	• 1994: $47,012
• 2014: $7.25	• 2014: $53,891

Sources: Car, average price according to USA Today; House, median price according to U.S. Census Bureau; Minimum wage, Department of Labor; Family income, CNN/Money and U.S. Census Bureau.

"For example," Doug continued, "you could buy a new car in the '70s for about $4,000, but it might not have a radio or air conditioning. You can't buy a new car without those things now. And some portion of what you'll pay for your new car now — about $30,000 — reflects those improvements. What this means for the calculation of CPI is that BLS adjusts the price of the old car — makes a guess as to what it would have cost then if it did have a radio and air conditioning."

Is Inflation Understated?

Some analysts and institutional investors argue that quality adjustments, as described in Doug's car example above, have the effect of understating CPI.

"If you are using CPI to set your savings goals, it probably is an understatement. But I think the main point for investors is that there is nowhere to go but up. The Fed views inflation as too low. The Federal Open Market Committee still worries about a nasty trip into the land of deflation and continues to pursue an expansive monetary policy to move their preferred measure of inflation — the PCE Core Price Index — towards the goal of 2.0 percent from its current level of 1.24 percent," says Doug.

Hedging against Inflation

Some investments, such as bonds and money market funds, have more sensitivity to the rising cost of living than others. Utilizing inflation hedging strategies such as asset allocation may help preserve your wealth. Diversifying a portfolio between equity and bond funds, for example, may help cushion a portfolio during inflationary periods.

Additionally, finding a way to redirect a few dollars more to your investment and savings programs can naturally help provide a potential cushion against future cost increases. The effect of compounding investment earnings can be quite dramatic, too, a fact Albert Einstein noted in his famous quote that the effect of compounding was "the greatest mathematical discovery of all time." That's because compounding may help you outpace inflation by earning money not only on your savings, but also on any income dividends or capital gains that your portfolio accumulates.

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News Briefs

Marc Johnston Take Reins of Daily Income Fund

In May 2015, fixed-income analyst Marc Johnston was promoted to portfolio manager of the Daily Income Fund. Marc has been on the investments staff since 2001. He holds the CAIA (Chartered Alternative Investment Analyst) and CFP (Certified Financial Planner) designations, as well as FINRA Series 7 (General Securities Representative) and Series 63 (Uniform Securities Agent State Law) securities licenses.

Marc Johnston, CFP, ChFC, CAIA
Money Market Portfolio Manager

Greg Halter Joins Asset TV Panel

Homestead Value and Small-Company Stock Funds co-manager Greg Halter was invited to be a panelist at an Asset TV roundtable discussion on small-cap investing. In this videotaped discussion, Greg provides insights on opportunities in small-cap stocks and the team's investment philosophy. A video of Greg's remarks will be posted on the "News & Media" section of our website as soon as it's available.

Gregory Halter, CFA
Senior Equity Portfolio Manager

HSCSX Makes Kips 25 List for Third Year

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.

Past performance does not guarantee future results. 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 Small-Company Stock Fund's expense ratio is below the peer group average, as determined by Lipper for the period ended December 31, 2014.

Upcoming NRECA Events

Homestead Funds will be attending this year's INTERACT conferences, kicking off **July 11 in Boston** and repeating on **August 22 in Denver.** We'll also be on-site at NRECA's 2015 Tax, Finance & Accounting Conference for Cooperatives starting **August 2 in Denver.** If you are attending any of these NRECA events, be sure to take a minute to visit Homestead Funds' booth.

Investing for Your Future

Through our compact family of eight no-load mutual funds, Homestead can help you meet a single financial need or build a comprehensive investment program according to your personal goals. If you need help customizing your investment program, a client services associate can help. Give us a call at 800.258.3030.

Money Market Funds	
Short-Term Less than one year	• Daily Income Fund
Bond Funds	
Medium-Term Less than five years	• Short-Term Government Securities Fund • Short-Term Bond Fund
Equity Funds	
Long-Term More than five years	• Stock Index Fund • Value Fund • Growth Fund • Small-Company Stock Fund • International Value Fund

An investment in the Daily Income Fund is not insured or guaranteed by the Federal Deposit Insurance Corporation (FDIC) or any other government agency. While this fund seeks to preserve the value of your investment at $1.00 per share, it is possible to lose money by investing in this fund.

A Few Dollars More: Saving As Little As 2% More A Year Can Make A Big Difference

To retire comfortably and keep up with inflation, one rule of thumb asserts that investors will probably want to receive 85 percent of preretirement income for each year in retirement. For example, someone earning $60,000 year would need about $51,000 a year (85 percent of $60,000) to retire comfortably.

Presuming that person lives another 20 years in retirement, that individual may require more than $1 million to maintain the standard of living he or she enjoyed prior to retirement — a daunting sum on the face of it.

Contribution rate (% of salary)	Savings each year	Savings over 30 years	Assuming 7% return a year, investment grew to…
9%	$5,400	$162,000	$552,673
7%	$4,200	$126,000	$429,857
The difference	$1,200	$36,000	**$122,816**

The examples are intended for illustrative purposes only and are not a prediction of investment results. One's own account may earn more or less than these examples and income taxes may be due upon withdrawal. Rates of return vary over time, particularly for long-term investments. Investments offering higher rates of return involve a higher degree of risk to principal. The annual rate of return is compounded at the same frequency as the contribution. This hypothetical example is based on weekly contributions to a tax-deferred retirement account and a 7 percent annual rate of return compounded weekly.

Closing a retirement income gap like that, however, can begin with small steps. Let us assume an individual earned $60,000 a year. If our hypothetical saver put aside 7 percent a year for 30 years, that person would have seen their investment grow to $429,857. In contrast, let us assume our saver managed to add another $23 or so a week — the equivalent of increasing contributions by 2 percent a year.

Through compounding, that additional amount could have provided $122,816 more money over the course of 30 years, while growing to $552,673.

Not an Easy Time for Investors

With the stock market at historically high levels and bond prices higher thanks to years of low interest rates, it's understandable that investors might be cautious about their commitment to these asset classes. Over long time periods, however, stocks and bonds have a solid track record of generating returns in excess of inflation.

Investors who expect their portfolios to outpace inflation and whose time horizons allow them to endure some volatility in the short run should remain committed to a diversified strategy that includes stocks and bonds. Yields on more conservative options, including money market securities, are at negative real (inflation-adjusted) levels.

The sooner you take action to control what you can and diversify your portfolio with investments that have the potential to offset inflation, the better off you could be. The good news is you don't have to go through your "inflation fighting" experience alone. Consider reaching out to a Homestead Funds' client services associate. Together, you can explore ways to temper inflation's impact through thoughtful allocations to strategies that can help preserve and grow your nest egg. Call us at 800.258.3030.

Homestead Funds

National Rural Electric Cooperative Association

A Touchstone Energy® Cooperative