Horizons 4Q | 2015

A Quarterly Newsletter for Homestead Funds' Shareholders

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Beyond the Noise

In our view, the core trends in the economy and the markets are positive, overall. This may surprise market watchers, whose laundry list of worries seems to grow every day. Slowing economic growth in China and contraction in Japan. The downward spiral of energy-related commodities. Fears of terrorism and other geopolitical events. Hand-wringing about interest rates and looming U.S. elections. A quick look at market news can seem scary, indeed. *(continued on page 2)*

Taking Stock of a Bumpy Year

2015 was a year when volatility returned to stock and bond markets. After 10 consecutive quarters of positive returns, the S&P 500 Index turned sharply negative in the third quarter, then rallied back in the fall.

Stephen Kaszynski, CFA
Director, President and CEO

As the S&P 500 is poised to finish 2015 with moderate gains, we reflect on some of the broader trends.

Rate Increases & Aftershocks

The Federal Reserve's plan to raise interest rates has been a prominent theme for years. Here is our view of the road ahead as policymakers finally set off on a normalizing path.

- **Low and slow:** We expect rate increases in small steps over a long period.
- **Early headwinds, then calm:** Historically, the first increases tend to set off stock market aftershocks, but 12 months out, returns often recover.
- **Uncharted territory:** Unlike most rate hikes, policymakers are not trying to slow an overheating economy.

Read on in this issue to see what rising rates mean for bond portfolios.

Underlying Strength

Company fundamentals—like sales and earnings numbers—are healthy in aggregate, especially if we exclude energy-related companies recovering from depressed commodity prices.

We also like the stability in employment and consumer spending. The uptick in U.S. household formation, which we noted in the last issue of *Horizons*, continued to strengthen through the year.

Globally, a number of risks have investors on edge, including the looming 2016 U.S. election and of course the unknowable impact of geopolitical events that continue to plague world citizens. But we see encouraging growth in the Eurozone. China and other emerging economies may have more upside as they regain footing from the headwinds of a strong U.S. dollar and weak commodities.

Long-Term Focus

After years of calm, volatility can feel unsettling. Yet it can be a good thing, too. Market swings can create opportunities for portfolio managers to pick up names they like at attractive prices.

Over long periods, history shows that stocks and bonds have positive returns. To us, the cost of missed opportunities for growth is greater than the temporary discomfort of volatility. We continue to focus on having your money work as hard as you do.

Steve's remarks were prepared as of November 17, 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. Unless otherwise notated, performance of indices do not account for any fees, commissions or other expenses that would be incurred. Returns do not include reinvested dividends.

Homestead Funds

"The markets were jittery in the second half of the year," says senior equity portfolio manager Greg Halter. "After stock markets pulled back in August, everyone seemed to be waiting for the other shoe to drop." But Greg and his colleagues believe that the fundamentals—objective measures of business and economic activity—show relative stability, beyond the noise. "We don't think that sentiment always matches up real-time with strength in the economy and within many companies," says Greg.

What's Good? The Fundamentals.

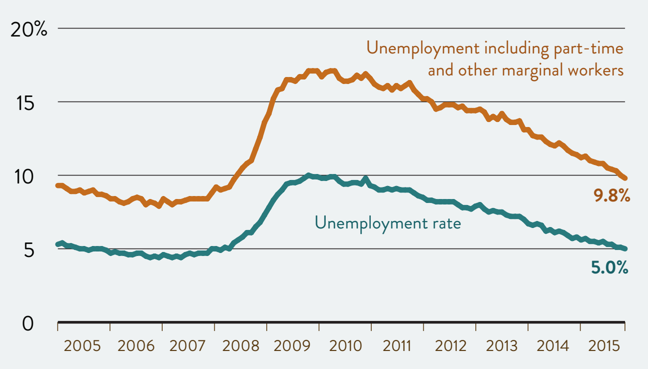
So what are the signs of strength? Sales, for starters. Companies in the S&P 500 Index are reporting decent revenue numbers for the year. Excluding energy companies, aggregate sales for S&P 500 companies are projected to be up 1.9% from 2014.

The same holds true for earnings. The projections for S&P 500 company earnings are down a bit for 2015, about −0.3% compared to 2014, but the energy sector is again dragging down totals. Excluding energy, S&P 500 companies are estimated to have grown earnings in 2015 by 6.9%.

Another bright spot is unemployment, which continues to tick downward. The simple unemployment rate does not tell the whole story; some people are working part-time work even though they want full-time, or have stopped searching because they are too discouraged. But a broader measure of unemployment, which includes involuntary part-time workers and the 'marginal' labor force, is also trending downward.

"It may not always feel like the economy is strong, but we see signs that the labor market is getting closer to so-called 'full employment'," says senior fixed-income portfolio manager Doug Kern. While the broader unemployment measure is still near 10%, Doug notes that this figure rarely dips below 8–9%, even in tight labor markets. (See figure.)

Unemployment measures continue to show improvement



Source: Bureau of Labor Statistics, as of 10/31/15. 'Marginal workers' includes people who want and are available for work and have searched for a job in the last 12 months, but were excluded from the general unemployment measure because they had not searched for work in the previous 4 weeks.

> *"In our investing practice, we aren't immune to the noise; we have to try to mitigate some of the short-term movements. But we care more about individual companies over long periods."*

The prospect of higher interest rates is also a sign of relative strength. As Homestead CEO Stephen Kaszynski observes, "The Fed waited so long on rates because they wanted more certainty on economic growth first. Their job today is to bring rates back to a more normal zone without damaging that growth in the process."

Seeing More Differentiation among Companies

One trend our portfolio managers see is more differentiation among sectors and companies, in terms of performance. Since the recovery began in 2009, the story for many stocks has been "a rising tide lifts all boats." Our managers think that era has come to an end.

One example is the energy sector, which has struggled in the face of weak commodity prices. Doug has seen the effect in bond markets, too. "High yield bonds from energy companies had a very rough year, and we saw defaults go up," says Doug. He sees a changing outlook for riskier borrowers at large with interest rates on the rise: "Low-quality companies no longer get low borrowing rates just for showing up."

Our portfolio managers actually welcome this environment. "When the whole market is going up, stock picks may not matter," says Greg. "But when we have these periods of volatility, that's actually a window for us to purchase names that we've had an eye on and want to get at the right price."

Not Immune to the Noise, but Care More about Companies

The principle behind Homestead's investing style is a focus on the long term. So while we have to guide portfolios through these periods of short-term volatility, we believe it's the long-term fundamentals that determine returns over time. As Greg says, "In our investing practice, we aren't immune to the noise; we have to try to mitigate some of the short-term movements. But we care more about individual companies over long periods."

Keeping Finances on Track throughout Your Life

Each phase of life brings particular needs and challenges for your finances. And managing your money wisely entails balancing your current needs with consideration of your future needs. Here we run through key priorities for different points in your career, and offer tips to help you keep your savings and investments on track.

Early Career

When starting out, one top financial planning priority should be to build rainy-day savings. It's tough to save when you're earning early-career wages and may have student loans. But an emergency fund cushions the shocks that adult life can bring, including periods of unexpected unemployment, or big outlays like car repairs or medical bills.

Once you have a nest egg worth three to six months of expenses, start saving for retirement. Investing is about compound returns: the earlier you start, the more time your investments have to grow.

TIP: If your employer does not offer a 401(k), Roth IRAs can be especially attractive for younger investors who have a longer timeline to let investments grow tax-free.

Midcareer

As you get established in your career, you'll probably face major purchases such as a home or car. You may also be supporting a growing family or helping aging parents. But be sure not to neglect your own saving needs. Try to contribute the maximum amount to 401(k) plans or IRAs. Keep those rainy-day funds too, in case of emergencies.

It's also a good time to start thinking about your children's education. Education Savings Accounts and UGMA/UTMA accounts are designed for minors and are worth considering.

TIP: To learn more about education savings options, look for a paper called ***Saving for Education*** in the *Resources & Forms* section of homesteadfunds.com.

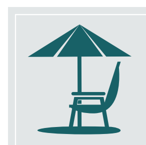
Late Career

At this stage, your priority is to be on track with retirement planning. Keep contributing as much as you can to retirement accounts. Wages and income can be highest late in your career, so take advantage by putting a higher amount into savings if possible.

As your investment timeline gets shorter, you'll also want to put more emphasis on protecting savings while still investing for growth. That may include a mix of investments suitable for a shorter time frame, such as money market or short-term bond funds, alongside long-term investments like stock funds.

TIP: Check on your accounts to make sure you know how you are invested.

Retirement



In retirement, you'll want to protect your savings by choosing a more conservative mix of investments. It's also a good time to check the beneficiary designations for your IRA and other accounts.

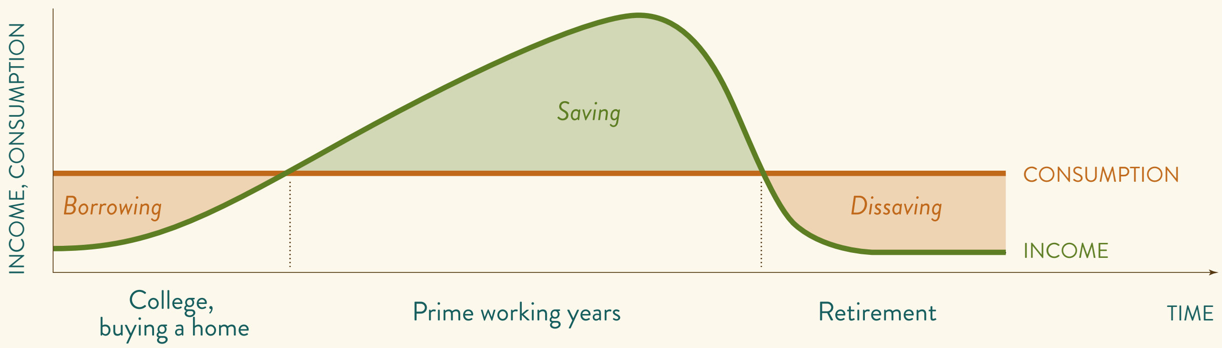
As you draw funds from savings, be sure to take the most tax-efficient mix of distributions, since different tax laws apply to different types of accounts. Homestead offers a service that can automatically move money from your investment accounts to your bank account.

TIP: Review the IRA rules for required minimum distributions. There's a helpful overview of the rules on our website. Look for a paper called ***Taking Your Required Minimum Distribution*** in the *Resources & Forms* section of homesteadfunds.com.

Visit Us Online

Balancing the future and the present is an ever-changing challenge when it comes to saving and investing. For more tips on managing your finances, including guidance for choosing investments, explore our investment planning insights online. You'll find educational pieces and helpful tips at homesteadfunds.com by clicking on ***Investment Planning.*** ✱

Chart of income over the life cycle from St. Louis Fed



The life cycle theory of savings suggests that people prefer smooth consumption over their lifetime. Workers can smooth their consumption by borrowing while they are young, saving in middle age and "dissaving" during retirement.

Source: https://research.stlouisfed.org/pageone-economics/uploads/newsletter/2014/PageOne1114NEW.pdf

News Briefs

Small-Company Stock Fund Noted in Investor's Business Daily

Investor's Business Daily recently acknowledged Homestead's Small-Company Stock Fund and its performance relative to mutual fund peers and the broader stock market. The article, titled "Small-Cap Mutual Funds Hang Tough; Homestead Among Leaders" was published on October 13, 2015. You can read the article in its entirety on the ***News & Media*** section of our website.

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. Investing in mutual funds involves risk, including the possible loss of principal.

Introducing Darryl Keeton

Meet the newest Homestead Funds team member, Darryl Keeton, who joined in September. Darryl has extensive experience directing financial services companies' relationships with both institutional and advisor clients. In his role as head of distribution, he will be doing more to identify how our mutual fund strategies can support co-op business objectives. He'll be in the field soon and looks forward to partnering with CEOs, CFOs and benefits administrations.

25th Anniversary Videos

Homestead Funds turned 25 this past November, a milestone we celebrate with our shareholders, colleagues and many in the rural electric cooperative community who provided the vision and leadership necessary for our start. To acknowledge our silver anniversary, we filmed a series of short videos that can be viewed on our website, homesteadfunds.com. Each video features a member of the staff or one of our colleagues from the cooperative community who offers a view of what makes us unique.

Rising Rates: the Story of the Year, for Years and Years

Some days, it feels like the markets have been talking about interest rate increases forever. Now that the time looks to have finally come, we anticipate some anxious market adjustments around the early months of rate hikes. Yet, our portfolio managers make the case that rising rates do not spell doom for short-term bonds. Below, Doug Kern, portfolio manager of the Short-Term Bond and Short-Term Government Securities Funds, shares his perspective on rising rates and the implications for bond investors.

Q. What's the usual scenario that causes policymakers to raise interest rates?

Typically, policymakers raise interest rates, also known as "tightening" monetary policy, to slow down an overheating economy. The Federal Reserve usually heads down this path when wages or other sources of inflation are moving upward too quickly.

Q. But inflation doesn't seem like the biggest worry today. What's different?

The current market environment is unusual because rates have been held near zero for almost seven years. What's more, the economy has recovered in such a slow and protracted process that the overheating phase is not yet taking hold. Inflation pressures remain low, especially with weakness in commodities, which feeds into lower energy prices.

So this rate hike is different. The goal is not to slow down the economy, but rather to bring rates back into a more normal zone without damaging good economic growth.

Q. When rates go up, don't bond prices go down?

Generally, yes, when rates go up, the prices of existing bonds go down. This effect is most pronounced on the longest-term bonds, like 10- or 30-year bonds.

But a change in bond price—the appreciation or depreciation—is only one component of total return for a bond or a bond fund. For a diversified and short-term bond fund like ours, those price movements are a very small fraction of total return. Most of the return over long periods comes from income, the coupons paid on bonds. This is true even when rates are climbing.

Q. What are the other effects of interest rate increases, besides bond prices?

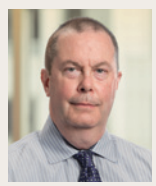
Higher interest rates imply a higher cost of borrowing for companies, especially for the "riskier" enterprises out there. As these riskier companies bear a higher cost of capital, that can change their balance sheets and cash flow dramatically, even leading to default for some issuers.

For instance, some sectors have really struggled because of low commodity prices, like oil and gas firms or miners. Some of these firms are already facing cash flow problems; higher borrowing costs can be the straw that breaks the camel's back.

Overview and Management

The Short-Term Bond Fund (HOSBX) is managed to earn a competitive level of interest income, consistent with a low level of share-price volatility. At least 80% of the fund's net assets are invested in bonds that are in the three highest credit categories. The fund can hold U.S. government securities as well as corporate bonds and other types of debt instruments. Under normal circumstances, the fund's weighted average maturity is expected to be three years or less.

The Short-Term Government Securities Fund (HOSGX) is managed to earn a competitive level of interest income, consistent with a low level of share-price volatility. The fund's primary holdings are securities whose principal and interest payments are guaranteed by the U.S. government, such as U.S. Treasury bills and notes. Government-guaranteed issues pose limited risk of default: If the issuer were unable to make payments, the government would. But the fund's yield and share price will fluctuate, reflecting changes in interest rates. Under normal circumstances, the fund's weighted average maturity is expected to be three years or less.



Doug Kern, CFA
Senior Fixed-Income Portfolio Manager

BS in Business Administration and MBA in Finance, Pennsylvania State University

Doug has been with RE Advisers since the company's launch in 1990.

This is certainly not true for all issuers. Banks, for instance, have better positioning in higher interest rate environments, because their revenues go up. As we assemble a portfolio, these are the considerations for selecting a mix of issuers.

Q. Does the outlook for rising rates change the role of bonds in client portfolios?

Bonds still play a crucial role in portfolios. For many clients, they can be a way to preserve wealth while earning income to offset inflation. Many investors who choose stocks for growth also want to mitigate some of the stock market's dramatic moves, and bonds do an important job of offsetting volatility. Even in a rising rate environment, the case for bonds is strong.

Doug's remarks were prepared as of November 17, 2015. Investments in fixed-income funds are subject to interest rate, credit and inflation risk. Interest rate risk is risk that a change in rates will negatively affect the value of the securities in the fund's portfolio.

10 Things to Know about Capital Gains

Capital gains can impact your taxes in a few ways. Here are 10 things to know about capital gains as we approach tax season and details to help you put distribution activity for RE Advisers' actively managed equity funds in perspective.

1. Any time a stock or fund's price goes higher than where you bought it, that's a capital gain.
2. But it's not a *realized*—and thus taxable—capital gain unless sold or liquidated for a profit. *Unrealized* gains are not taxable.
3. Realized capital gains are not relevant to investors in tax-free accounts like IRAs.
4. For mutual fund investors in taxable accounts, there are two kinds of realized capital gains: when you sell your mutual fund shares for a profit, or when securities within the fund are sold or liquidated for a profit.
5. Those pass-through gains from portfolio activity can be classified as short- or long-term, for tax purposes, just like your direct stock or fund sales.
6. Realized capital gains can be taxable whether they were paid to shareholders or reinvested.
7. High trading activity in mutual funds can generate more frequent and larger taxable capital gains...
8. ...but buy-and-hold investing, with longer holding periods and lower turnover, can create fewer taxable capital gains.
9. Taxable capital gains can be offset by prior years' losses, when available.
10. Realized taxable gains can be generated when a portfolio holding is sold, but also if there are mergers, acquisitions or other corporate events for holdings in the fund.

Shareholders in the Value and Small-Company Stock Funds may notice a slight uptick in capital gains distributions for 2015 relative to the prior year. Our portfolio managers note that there was slightly higher repositioning activity as they found new opportunities during the year. It was also a record period for merger & acquisition activity. These and other corporate restructurings are taxable events. Finally, in 2015, the funds did not have prior years' losses available to offset gains. But shareholders should rest assured that the management style for these funds continues to be a long-term, buy-and-hold strategy with low turnover relative to actively managed fund peers.

Tax Forms You May Receive

If you have a taxable account, you'll likely owe income tax on dividends, interest income or capital gains distributions, whether paid as cash or reinvested. If you sold shares for a profit, you may owe capital gains tax.

For IRA holders, your tax liability will be different. For Traditional IRAs, you'll generally owe income tax on amounts withdrawn, plus a 10% premature distribution penalty on withdrawals before age 59½. Roth IRA distributions are tax-free as long as you are at least age 59½ and the account has been open for five years or more.

- **IRS Form 1099-DIV** reports any stock dividends, coupon income or capital gains earned by your funds.
- **IRS Form 1099-B** lists proceeds from a sale or exchange of fund shares held in a taxable account. Refer to this form plus your year-end account statements to calculate your basis and determine the amount of any tax due.
- **IRS Form 1099-R** reports distributions taken from an IRA or other type of retirement account and the amount withheld for payment of federal income tax.

Homestead Funds does not offer tax advice. Please consult the appropriate professional regarding your individual circumstances.

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National Rural Electric Cooperative Association

A Touchstone Energy® Cooperative