Homestead
Funds

4301 Wilson Blvd.
Arlington, VA 22203

800.258.3030

www.homesteadfunds.com

Q1 2022: The Heat Is On

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Mark Santero: Hi, welcome to the Homestead Funds first quarter of 2022 market and funds review. We are labeling this update "The Heat Is On," and you'll hear more about that with our two presenters today.

I'm Mark Santero, president and CEO of Homestead Funds. And I'm pleased to be joined by our two senior portfolio managers — Mauricio on the fixed-income side and Prabha on the equity side — and they will share with you what's going on in the markets. It's been quite an interesting first quarter to '22, almost epic when it comes to volatility in the markets and what has transpired. We look at what went on in the first quarter; we will also talk about what we see going ahead.

So, the agenda [slide 4]: As I just mentioned, we will give macro-economic conditions and factors for the first quarter. We'll talk then about fund absolute and relative performance. Prabha and Mauricio will speak about the drivers of return for the Homestead Funds. And then last, but certainly not least, what is our outlook and fund positioning for the remainder of '22, appropriately named "The Heat Is On." I'm going to turn it over to Prabha and kick off what happened in Q1 to put things in perspective. Prabha?

Prabha Carpenter: Thank you so much, Mark. This quarter was marked, as Mark said, by volatility on a number of fronts [slide 5]: Geopolitics, the resurgence of the pandemic in China and concerns about inflation impacted returns across all asset classes. The fear that the war in the Ukraine becomes a larger war with the west has been a more recent concern. Supply chain issues, which we chatted about in the past, from strong consumer demand are being further aggravated by the war in Ukraine and shutdowns in regions within China. Energy, grain, critical materials are facing pricing pressure due to supply disruptions from the Ukrainian conflict. On the equity side, we are active managers with a long-term lens. We feel our portfolios are well positioned for favorable returns over the long haul. Now I'll turn it over to Mauricio for the bond market picture.

Mauricio Agudelo: Thank you, Prabha. The picture on the fixed-income side is very similar to the equity challenges that you faced during the quarter, Prabha. Inflation has been and continues to be a sticky issue. The Fed has signaled a more aggressive path towards tightening monetary policy in an effort to bring down inflation, although this is going to take some time. And even the Fed delivered the first post-pandemic rate hike of 25 basis points during the quarter. We still continue to see supply chain challenges. And additionally, the Russia invasion of Ukraine put upward pressure on commodities, driving producer prices even higher.

Against this backdrop, we saw Treasury yields trend higher during the quarter. For example, the two-year Treasury went up from 0.73% at the end of 2021 to finish at 2.34% at the end of the first quarter of this year, while the 10-year yield increased from 1.51% to 2.34% during the same period.

On a positive note, although inflation remains high, analysts are still quite a bit about the prospect for companies and strong profits during this period. The economy continues to perform well. The unemployment rate has declined from 3.9% to 3.6% during the quarter, and jobs — they remain plentiful as represented by the latest JOLT [Job Openings and Labor Turnover] survey. So, there are still reasons to remain optimistic out there.

Now, turning to performance for the Short-Term Bond Fund during the quarter [slide 7]. The fund outperformed the benchmark during the period by 22 basis points — the main driver being our underweight duration position versus benchmark mainly driven by the front-end part of the curve, that'd be the two year and in. On the other hand, corporate spreads experienced some widening during the period. And these detracted from performance in a relative basis, although we did see some recovery during the last two weeks of March.

In terms of portfolio positioning, we have covered some of our underweight duration as Treasury yields rose during the period [slide 8]. We felt that they offer more value, and the proposition of adding Treasuries at these levels of, say, 2.5% and the two-year — it became very attractive in our view.

Now turning to the Intermediate Bond Fund, the story is very similar in regard to performance; however, corporate spreads took a little bit more from the Intermediate Bond Fund [slide 10]. The fund outperformed only by two basis points. A challenging quarter for the [Bloomberg U.S.] Aggregate Index — nearly a 6% drawdown, something that we haven't experienced at least in the last 40 years given the inflation situation.

The fund benefited from being underweight duration. Additionally, the fund benefited from the underweight in the mortgage-backed security space, which helped offset some of the credit widening that took place in the quarter.

From a portfolio standpoint, we remain underweight mortgage-backed securities [slide 11]. We have reduced our corporate exposure somewhat, and we have added to U.S. Treasuries. This is all in anticipation and managing to the volatility that we are experiencing in the market, and as active managers, we strive to take advantage of these opportunities.

Now turning to the Rural America Fund, the fixed-income sleeve delivered similar returns [slide 13]. The main drivers of performance being underweight duration and our positioning in issuers that contribute to the growth of rural America helped the fund during the period. Now, Prabha, if you could give us some insight into the equity component of the fund.

Prabha Carpenter: Thank you, Mauricio. Regarding the equity sleeve for Rural America Fund, we declined about 5%, trailing slightly the Russell 3000 benchmark [slide 15]. The detraction was due to the sector allocation effect. What worked in the quarter? Rural-focused stocks in the industrials and financial sectors performed well. We're confident that rural economic themes such as agriculture and manufacturing and transportation will do well in ensuing quarters.

Now we continue with the Homestead Value Fund [slide 17]. We trailed our benchmark, the Russell 1000 Value, by about 200 basis points in the period. On valuation metrics, the fund looks cheaper and more profitable than the benchmark. What worked in the quarter? Health care, especially the biotech subsector, and industrials, especially government service contractors and aerospace and defense, with all the kinetic activity we're hearing about.

What detracted with the Value Fund? We were underweight energy, and the sector was particularly strong in the quarter for the reasons we've discussed, and that hurt our performance [slide 18]. Materials also detracted here; it was just an idiosyncratic one-off name that was particularly weak, but we have high confidence of the stock outperforming over the long haul.

The next fund is the Homestead Small-Company Fund [slide 20]. Here we were ahead of the Russell 2000 benchmark in the period by 78 basis points. What worked? Again, industrials helped —Triumph group was one example — but the defense contractors ManTech and CACI also did well. Financials worked [slide 21]: A few banks were up in the high single digits, and a capital markets holding that benefits from market volatility was strong and contributed to results.

What detracted? Again, energy was strong, both in large- and small-cap, and we didn't have exposure to small-cap energy. Now back to Mark Santero.

Mark Santero: Thank you, Prabha. Thank you, Mauricio. It's always important to look back and see how the funds performed. But, as we've said in the past, that is now in the rearview mirror, and what our investors want to know is what's ahead in not only the markets, but what do we perceive to be coming ahead? And how might that affect the portfolio?

Before I turn it back to Mauricio and Prabha about what's ahead, I did want to mention what's ahead for the funds in the second quarter. We have two significant birthdays for our funds in the second quarter. Specifically on May 1st, the Rural

America Growth & Income Fund celebrates its one-year anniversary. And we're very excited about the prospects of this fund going forward and the companies and the securities that are invested in rural counties. And also, we have a three-year anniversary for the Intermediate Bond Fund, which is quite a significant accomplishment and one that we're very proud of how it's performed over the past three years.

So that's what's ahead from the fund standpoint. Now what's ahead from the market standpoint? I am going to turn it back to Mauricio to give a little bit of what our outlook is for rates going forward. Mauricio?

Mauricio Agudelo: Thank you, Mark. We like to highlight this chart [slide 23]. We have seen it before. We like to present it again because we like to illustrate here that the Treasury market has already priced in some of the rate hikes that are being driven by the Fed in the near future. So in a way, yes, we have felt a lot of pain, but as I like to say nowadays, with higher yields and higher coupons, we are putting back income into fixed income. So, we are coming up very low rates from last year; now we have more coupon — that carry will help our investors in the future. As a matter of fact, as of today, April 27th, the futures market is pricing in nearly 10 rate increases of 25 basis points between now and the end of February 2023. We are also watching carefully the mortgage market, housing, the effects of higher rates. How is this going to play out? Just looking at bank rate, the 30-year mortgage rate has climbed from 3.27% at the end of 2021 to about 5.42% currently, although we do think that there will be opportunities in the MBS [mortgage-backed securities] market in the near future.

We remain optimistic in investment-grade corporates. As mentioned, corporations are still on a strong footing; they were able to refi to extend debt last year; they have been able to pass cost increases to consumers. That being said, we remain mindful of the volatility, and we will continue to experience the volatility. But as mentioned, we are active managers, and we seek to take advantage of this volatility coming up. And now, Prabha, if you could tell us what you see ahead on the equity side.

Prabha Carpenter: Thank you, Mauricio. Just to reiterate, on the equity side, we think the U.S. economy is strong, rich in resources. Central bankers have tools. And as Mauricio mentioned, earnings. This has been earning season, and approximately 80% of the reported results have been ahead of expectations, and we're only partway through the earnings results.

Mauricio mentioned housing. This chart shows recession risk with changes in mortgage rates and gasoline prices and the impact on consumer spending [slide 24]. And when the measure is above 10, the yellow line, recessions or slowdowns ensue — not a guarantee, but something to be aware of. But we're not there yet. We're not near that threshold. So, over the long term, our portfolios should benefit from the strength of our quality holdings and our active management.

And now I turn it back Mark Santero.

Mark Santero: Thank you, Prabha, and thank you, Mauricio. One thing that Prabha had mentioned, and I believe Mauricio as well, is we take a long-term view on some of the cyclical trends that happen in the market.

We always welcome your feedback; we always welcome your questions, and we certainly always welcome your concerns. My number is right here, listed on this page, as well as my email [slide 25]. Please, take any opportunity to give us a call or shoot me an email if you have any questions, concerns or you want to reevaluate your investment portfolio. Most importantly, we want to thank all our investors for their support and their trust in the Homestead team, and we look forward to serving you in the future. We thank you, and we hope everyone has a very good second quarter and rest of '22.

Top holdings for the Small-Company Stock as of March 31, 2022:

Applied Industrial Technologies, Inc.	3.6%
Avient Corp.	3.3%
ManTech International Corp.	3.1%
Summit Materials, Inc.	3.1%
Atkore Inc.	3.1%
Encore Capital Group, Inc.	3.0%
AMN Healthcare Services, Inc.	2.9%
Eastern Bankshares, Inc.	2.8%
Medpace Holdings, Inc.	2.7%
Glacier Bancorp, Inc.	2.7%
Total	30.3%

Absolute return is the return that an asset achieves over a specified period.

Asset-backed securities (ABS) are bonds or notes backed by financial assets.

Basis points (bps) refers to a common unit of measure for interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01%, or 0.0001, and is used to denote the percentage change in a financial instrument.

Beta is a measure of the volatility—or systematic risk—of a security or portfolio compared to the market as a whole.

Bloomberg U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market.

Blended Index is composed of the Russell 3000 and the Bloomberg Intermediate U.S. Government/Credit Bond Index in a static 60/40 allocation. The Russell 3000 is a market capitalization-weighted benchmark index made up of the 3,000 largest U.S. stocks, which represent about 98% of the U.S. equity market. The Bloomberg Intermediate U.S. Government/Credit Bond Index is a broad-based flagship benchmark that measures the non-securitized component of the U.S. Aggregate Index with less than 10 years to maturity. Indices are unmanaged and investors cannot invest directly in an index. Unless otherwise noted, performance of indices does not account for any fees, commissions or other expenses that would be incurred. Returns may or may not include reinvested dividends.

Commercial mortgage-backed securities (CMBS) are fixed-income investment products that are backed by mortgages on commercial properties rather than residential real estate.

Duration is the weighted average of the times until those fixed cash flows are received.

Mortgage-backed securities (MBS) are an investment similar to a bond that is made up of a bundle of home loans bought from the banks that issued them.

Price to earnings (P/E) is the ratio of a company's stock price to the company's earnings per share. The ratio is used in valuing companies.

Relative return is the difference between the absolute return and the performance of the market (or other similar investments), which is gauged by a benchmark.

Return on equity is a measure of the profitability of a business in relation to the equity, also known as net assets or assets minus liabilities.

Russell 3000 Index is a market capitalization-weighted benchmark index made up of the 3000 largest U.S. stocks, which represent about 98% of the U.S. equity market.

Russell 1000 Index is a subset of the Russell 3000 Index and measures the performance of the 1,000 largest companies in the Russell 3000 Index. The **Russell 2000 Index** is a subset of the Russell 3000 Index and measures the performance of the 2,000 largest companies in the Russell 3000 Index.

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.

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