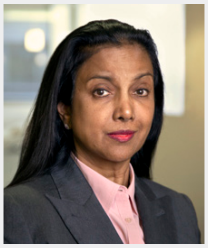
Our Perspectives: Consistency and Collaboration in Equity Management

Homestead Funds



Prabha Carpenter, CFA®

Senior Equity Portfolio Manager

Prabha manages the company's large- and small-cap value strategies. Prior to joining RE Advisers in 2002, she was a portfolio manager for a division of GEICO Corporation, where she oversaw a regional equity fund. Prabha began her career with GEICO as an equity analyst with a focus on stocks in the financial and consumer sectors. She has also held senior positions at bank trust and commercial finance companies, where she managed convertible securities funds. She served as a past president and board chair of the CFA Society of Washington, D.C. Prabha is a member of 100 Women in Finance and is included in the group's female fund manager listing.

She is a graduate of the University of Madras, where she received a Bachelor of Arts degree in economics. She received her Bachelor of Science degree in business economics and an MBA with distinction in finance from American University. Prabha holds the Chartered Financial Analyst designation.

Jim Polk, CFA®

Senior Equity Portfolio Manager

Jim co-manages the company's large- and small-cap value strategies. Prior to joining RE Advisers in 2019, he was a portfolio manager at Putnam Investment Management, LLC, where he managed small-, mid- and multi-cap value-oriented mutual funds.

He is a graduate of Colby College, where he received a Bachelor of Arts degree in English. He received his MBA from the Olin Graduate School of Business at Babson College. Jim holds the Chartered Financial Analyst designation.

RE Advisers, investment advisor of Homestead Funds, has a long history of managing institutional and mutual fund portfolios. Our equity team today remains true to its roots, being composed of traditional value managers. But it has evolved in step with new technologies, the addition of new team members, and the influx of new ideas and experience each new team member contributes. As we approach the company's 30th anniversary, we'd like to give our investors an update on team dynamics — sharing both a retrospective and current view of the investment philosophy and process.

What follows is a Q&A with co-senior equity portfolio manager Prabha Carpenter, our longest tenured investment professional with over 18 years at the firm, and co-senior equity portfolio manager Jim Polk, who joined RE Advisers in January 2019.

Q: There is an interesting story behind the fund company's start. Can you explain that?

PRABHA: Sure. Homestead Funds was established by the National Rural Electric Cooperative Association (NRECA) in 1990 for the association's members, seeking to give their employees access to the same high-quality, affordable investment options that were available through NRECA's employer-sponsored benefit programs. While the fund complex is open to the public, the fund company's reason for being is tied to the electric cooperative's mission of service, and this original mandate informs our approach even today. We are a shareholder-focused organization, looking to thoughtfully balance risk with the potential for reward and seeking to operate as efficiently as possible.

Q: Describe the equity investment philosophy of the team today. How has it differed from the past, and where would you like it to evolve?

PRABHA: We approach equity investing with the view that we are long-term partners and partial owners of the businesses in which we are investing. We generally seek established companies with products and services that are understandable in terms of the economics of their pricing and overall value to the markets.

JIM: In speaking about our philosophy, our approach today doesn't seem to be a change or shift. We continue to look at equities through a value lens, the way the team has always done. We continue to look for businesses with strong fundamentals that we believe will reward investors over the long haul. We look at earnings potential over the next three to five years. Our bias is to find higher-quality value companies.

Q: How would you describe the investment process? Has it changed over the years?

PRABHA: The approach we've refined — a course that has been in place since the funds' inceptions — is disciplined and very research-focused. We spend a lot of time digging through information about companies, interviewing management, asking questions and talking with each other to try to filter out the best ideas. The old saying, "Measure twice, cut once," is accurate for us. Our goal is to minimize turnover with the thoughtfulness of our approach. Taxes and transaction costs diminish returns.

JIM: To add to that, we continue to invest for the long haul, which is important to our shareholders. Furthermore, we don't expect to deviate from our bottom-up research focus. We are generalists with individual sector-specific focuses, and our process is collaborative, with multiple investment personnel on analyst calls, company visits and management meetings.

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>
> — Prabha Carpenter, CFA®

Q: How is the team structured today? What is the division of responsibilities within the team? Has this changed over the years?

PRABHA: It's always been a collaborative process, and that is how we will work going forward. We all have broad responsibility for and involvement in the funds — from idea generation through to portfolio construction and risk monitoring. That breadth of experience can help us identify niche investment opportunities others might miss. We believe strongly that cognitive diversity enriches the investment process.

JIM: While the members of the equity portfolio management team are all generalists, we look to the individual who has a previous analytical background in a particular sector. We all bring a certain expertise to the process. Prabha has industrials and financial expertise. Senior equity analyst Peter Blackstone, who joined in 2018, has energy and technology. Mark Iong, also a senior equity analyst, was added to the team in 2019 and contributes his focus on the technology and consumer discretionary sectors. I have health care. The team is also composed of investment professionals from different investment backgrounds (from large asset management firms to small boutiques) who possess different investment sources and points of contact, which help to bring different perspectives to idea generation for the portfolios.

Q: With four senior investment professionals in the group now, how do the team members triangulate and efficiently manage their time and responsibilities throughout the day?

JIM: As we have emphasized, the team is very collaborative. We believe the more inputs we can have into vetting a stock idea the better. We communicate regularly with each other about company meetings, analyst calls and conferences to allow for this.

Q: Homestead Funds has always emphasized being a "bottom-up" equity investor. Why is this important to the process, and has this been modified at all over the past 30 years?

PRABHA: The equity portfolio management team has always adhered to our bottom-up investment approach to manage the Small-Company Stock and Value funds. Past and present team members all possess a value approach to security selection. We believe our roots in managing retirement assets have provided our investors with competitive returns relative to their benchmarks over long-term holding periods. Buying good companies, one by one, at an attractive relative value, is who we are and who we have always been.

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Q: With regard to portfolio construction, how does the team manage portfolio exposures to the various sectors and industries? Is benchmark weight a significant consideration?

PRABHA: Historically the portfolio management team did have to adhere to certain constraints but generally was "sector agnostic." But with additional sector expertise on the team, we have evolved to be more "sector aware" respective to each portfolio's benchmark. Jim can expand.

JIM: With the formation and guidance of the investment committee in the fall of 2018, the portfolio management team has become more benchmark aware but not benchmark-focused. We are willing to make significant active investments in sectors that we believe provide more value. To manage the risk of the portfolios being substantially overweighted or underweighted relative to the benchmark, we use internal guideposts as a first-line check on our sector and industry allocations.

The investment committee, made up of RE Advisers' investment professionals plus the chief executive officer and chief operating officer, meets quarterly to ensure that we have a good rationale for our sector weights. We don't want to miss the forest for the trees. We all believe this will help to provide more consistent returns over the long term.

Q: What are the most important stock attributes to the investment process? Has this always been the case over the years?

PRABHA: The equity team looks to identify attractively valued stocks of companies whose management teams we believe to be judicious allocators of capital.

Specifically:

- Sustainable value proposition
- Quality businesses with significant competitive advantages
- Proactive management teams that are financial results-oriented, are judicious allocators of capital and have interests aligned with shareholders — with an owner's mentality
- Underappreciated long-term earnings potential
- Financial strength — strong balance sheets and a strong return on invested capital
- Attractive valuation on both an absolute and relative basis

JIM: To expand on Prabha's comments, equally important to value investing is what we seek to avoid.

In particular:

- Companies facing long-term secular headwinds
- Stocks with balance sheet issues
- Binary outcome situations
- Companies being disrupted and failing to embrace change — those lacking the adaptive quotient
- So-called value traps that lack catalysts to meaningfully alter their fundamental outlooks
- "Falling knives" stocks that have deceptively cheap valuations

Q: How does a stock get approved for purchase in the funds, and who ultimately has the final authority on buy/sell decisions?

PRABHA: Today with an expanded investment team, with different sector expertise, everyone on the team has input into stock selection and sector exposure; however, the ultimate decision is made by us, the co-portfolio managers, by consensus. We meet regularly to discuss position sizes and sector weights.

Q: How does the team determine the weight of a given security?

JIM: The weight of a security is determined by us, the co-portfolio managers, based on the team's collaborative fundamental analysis and our convictions. Normal position sizes are about 2% to 4% for the Small-Company Stock Fund and 2% to 5% for the Value Fund.

Q: How has the sell criteria evolved?

PRABHA: We seek to minimize turnover. Taxes and transaction costs diminish returns. The portfolio management team reflects the perspective of a long-term investor. Our critical sell factors include valuations that may appear excessive, deterioration of company fundamentals and whether better opportunities can be found.

JIM: In addition to Prabha's points, if a company can increase cash flows, sell at a reasonable price and remain profitable, then we are content to continue holding that company. We would look to sell if the fundamentals as Prabha outlined deteriorated, if valuations appeared excessive, if better opportunities were found elsewhere or if the position approached 5% of assets.

"We think both the quality of the business and the quality of the management are critical inputs."

— Jim Polk, CFA®

Q: What do you feel differentiates your philosophy from that of other "value biased" managers?

PRABHA: It is a philosophy that has stood the test of time. We are patient, long-term investors, and that approach goes hand in hand with our legacy as money managers for NRECA and its members. We've been able to focus on both capital appreciation and capital preservation over the long term rather than short-term performance pressures. And, as a boutique firm, we believe we have more flexibility and can be more responsive to investment opportunities than larger firms whose staffing structure might be more complicated. From a portfolio standpoint, that results in:

- Non-index-like construction
- Reasonable diversification with 50 to 60 holdings and focused to take advantage of analytical confidence
- High active share

JIM: We believe that just because a stock is statistically cheap, it doesn't always make it a value stock. For example, in this current environment, while energy stocks look very cheap, we don't think the sector represents good value generally. We think both the quality of the business and the quality of the management are critical inputs. We consider our philosophy to be quality value.

Q: Thank you, Prabha and Jim, for your insights. One last question: If you could take out your "crystal ball," what would the investment process look like in the next five years?

PRABHA: We believe in consistency and that our investment philosophy and process has stood the test of time; therefore, we do not foresee any material changes or modifications to our fundamental investment process, and five years from now our investment principles should look very similar to the current ones, specifically:

We strongly adhere to what we call our Stake in the Ground principles:

- Embrace the legacy of a value-based approach to investing.
- Look at quality opportunities that reward shareholders over the long run.
- Respect the legacy and augment or enhance it thoughtfully as active managers.
- Reduce friction costs by being thorough and thoughtful in the analytical process.
- Ask, What don't we know? What are we overlooking?
- Work together with mutual respect.

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Equity securities generally have greater price volatility than fixed-income securities and are subject to issuer risk and market risk. Value stocks are subject to the risk that returns on stocks within the style category will trail returns of stocks representing other styles or the market overall. Securities of small and midsize companies tend to be riskier than those of larger companies.

Smaller capitalization securities involve greater issuer risk than larger capitalization securities, and the markets for such securities may be more volatile and less liquid. Specifically, small capitalization companies may be subject to more volatile market movements than securities of larger, more established companies, both because the securities typically are graded in lower volume and because the issuers typically are more subject to changes in earnings and prospects.

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.

Investing in mutual funds involves risk, including the possible loss of principal. **Past performance does not guarantee future results.**

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