Horizons 3Q | 2017

A Quarterly Newsletter for Homestead Funds' Shareholders

In This Issue

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Reality Check: Is the Stock Market Overpriced?

Stocks have continued to set record highs in 2017, generating plenty of discussion about overheating, market bubbles and peaks. Are stocks drifting into overpriced territory, or could these lofty prices be justified?

The reality is: there is no "correct" value for stocks, exactly. Think of the price of your home: the market value fluctuates from month to month as the local market dynamics change. It's affected by the condition of your home, but also by how many other comparable homes are for sale at the time, how the local employment market and schools are doing, and how easy it is to get mortgage financing. The "correct" value is whatever you can sell it for on a particular date.

The same goes for stocks. The price of a stock fluctuates from moment to moment, and the "correct" value is whatever you can sell it for at that moment. Stock prices are typically affected by a company's recent news, but also the general mood of buyers and sellers, other data in the markets that day, etc. As long as there's a buyer, a stock isn't overpriced.

(continued on page 2)

Fact-Based Thinking

We Americans tend to be a gut-trusting people. Across the country, we show a high level of faith — not just in religion, but in all kinds of things we can't exactly prove. Almost half of us believe that horoscopes are based on science. A majority of Americans knock on wood to avoid bad luck. Many of us carry a good luck charm. The list goes on.

The value we place on intuition is a core part of our culture. Yet, some things in life should not be tethered to our feelings or gut instincts, but rather to pure empirical facts. Investing is one of those things.

Here we have all kinds of evidence about the range of outcomes for different types of securities over many different time frames. All of that historical data gives us a framework to consider what is possible or probable over short or long time periods. But there are myriad ways to evaluate this abundant stream of data, so one of the trickiest things is that it can be hard to tell when you're getting the facts, or which facts really matter.

With that in mind, we use this issue to do a little "reality check" in a few areas. We look at today's stock market — is it overpriced? — and we dig into the practical realities of some of our modern-day spending challenges. We review a few of the key facts about the kinds of investments most of us use, like historical returns for stocks, bonds, residential real estate or cash, in terms of upside and downside.

We also confront the reality that most Americans aren't spending very much time managing their finances and setting themselves up for a stable future. We have tips for small ways to improve that in your own life.

Stephen Kaszynski, CFA
Director, President and CEO

Investing may seem a bit like a sloshing pool where your only option is to close your eyes and jump in — but actually, your decisions can and should be based on how investments tend to behave over time. With that kind of foundation for your financial choices, you can have more confidence that your nest egg will be ready for you in the future.

Homestead Funds

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How Do We Measure What's "Normal" for Stock Values?

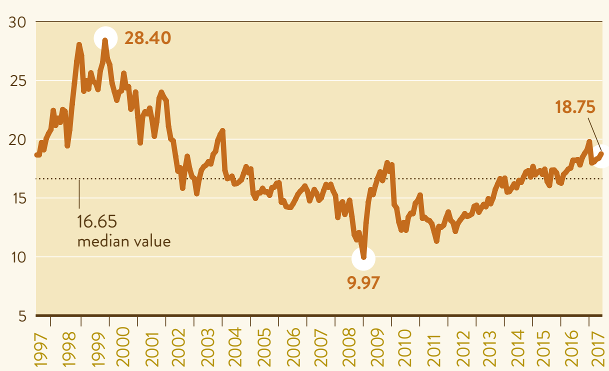
However, just because there's a buyer doesn't mean stocks aren't drifting into lofty territory. Indeed, there are observable reference points we can look at to see what's "normal" for stock prices.

Remember, a stock is just a tiny piece of an individual company. Its price is typically connected to the company's earnings — as earnings rise or fall, the stock price tends to rise or fall. In fact, the ratio of a stock's price to its earnings is a central measure of valuation for investors and portfolio managers. This is known as the "P/E ratio." The key barometer for many is the *forward* P/E ratio, which compares today's stock price to the estimated company earnings for the coming 12 months. It represents how much investors are willing to pay now for a share of the company's anticipated future earnings.

> *The ratio of a stock's price to its earnings is a central measure of valuation for investors and portfolio managers.*

When we look at the P/E ratio, it's clear that there's a wide range of "normal." Over the last 20 years, a period that encompassed the tech-bubble peak and the financial-crisis low, the P/E ratio for the S&P 500 Index ranged from less than 10 to almost 30. The median level is just under 17. Perhaps the best measure is the standard range — statistically speaking, the zone where the P/E ratio hovers about 66% percent of the time, a good measure of "normal." The standard range for the P/E ratio has been between about 13 and 20.

Forward P/E Ratio of the S&P 500 Index



Source: FactSet.

Not Cheap, But Still Normal

The latest P/E ratio value for the S&P 500 Index was around 19. High? Yes. But – still normal. In the tech bubble, the P/E was north of 20, at times even above 25. And that was the average for all stocks in the index. Individual tech stocks had P/E ratios that were astronomically higher, inflating the overall index average to record highs.

In hindsight, we know that tech-bubble stock markets were in the throes of "irrational exuberance," as then-Federal Reserve Board chairman Alan Greenspan famously put it. We also know that the financial crisis valuation lows, when the index P/E ratio was down around 10, quickly rebounded to more normal valuations. But we can also tell from these charts that market valuations persist. In the tech era, high valuations went on for years. Financial crisis lows were a bit more short-lived, but still carried on for quite some time.

The More Important Anchor Point

Perhaps the deeper point about stocks is this: we know their value can change a lot from day to day. The best expectations we can set for stocks build from this certainty. Historical data shows that stocks are likely to trend higher over time but are virtually certain to swing between peaks and valleys in the short- and medium-term.

As such, most investors should probably have some part of their portfolio invested in stocks — but stocks would typically be just one component of a bigger mix of investments that includes bonds, cash and maybe other types of assets.[1] Whether stock valuations retreat tomorrow or years from now, it is balanced exposure and reasonable expectations that will serve your portfolio best. ✸

[1] Diversification does not guarantee profit nor is it guaranteed to protect assets.

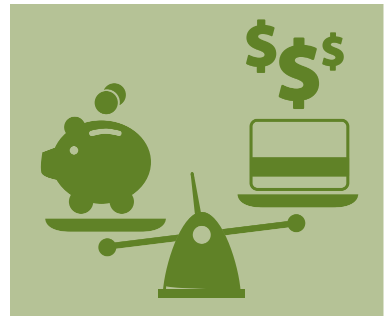
Indexes vs. Individual Stocks

When you hear about stocks reaching record highs, it's usually a reference to a stock index, such as the S&P 500. If you're invested in a passive investment strategy that tracks an index, such as an exchange-traded fund (ETF) or index fund, your investment should very closely track the performance of the index.

But news of index rallies or sell-offs may not tell you much about individual stocks, which may or may not have followed the broad market. When you invest in an actively managed fund, a portfolio manager or team is selectively choosing which stocks to own based on their research and judgment. Those stocks may be less affected by broad run-ups or drawdowns of the index at large. ✸

Your Spending, in Perspective

A meal out bought on a whim. A new sweater on sale. A few extra garden supplies we decide to treat ourselves to. These impulse purchases can add up quickly, and soon become the barrier between us and our good intentions to save. Yet the simple act of saving is the crucial first step toward future financial stability. Only after our nest egg is in place can we invest for the longer term.



Marketers are quite savvy to our weakness for impulse purchases. In fact, most stores, especially brick-and-mortar locations, are set up to maximize our likelihood of walking out with more than we intended to buy. Think of the candy shelf at the grocery store, conveniently placed to tempt shoppers on the way out. No one *needs* candy.

There are tools we can all use to resist impulse purchases. Using a shopping list, for instance, can keep us on track. Studies suggest we make fewer impulse buys when shopping online compared to shopping in the store, where we pass clever displays. Paying with cash rather than credit cards is another proven way to cut back on extras.[1]

Ways to cut back instantly on impulse purchases

- Always shop with a list and stick to it
- Shop online instead of in-person
- Pay with cash rather than credit cards
- Translate a purchase into "hours worked"

The "Hours Worked" Exercise

Consider those three impulse purchase examples: a restaurant meal ($15), a sweater ($35), and garden supplies ($100). Before you make that purchase, what if you stop to consider **how much time you'd have to work to earn that treat?**

Let's consider a hypothetical average American worker. The prevailing average wage in the U.S. is about $26/hour — that's the nationwide average for private (non-government) employees.[2] At that pay rate, the restaurant meal takes about **35 minutes of work** to earn. The sweater takes about **80 minutes**, while the garden supplies take about **four hours**.

But our hypothetical worker doesn't actually take home $26/hour. Let's assume he pays about 20% in taxes between federal, state and local bills. That means his take-home wage is more like $20.60/hour — so it actually takes even longer to earn those purchases: about **45 minutes** for the meal out, **100 minutes** for the on-sale sweater, and almost **five hours** for the batch of garden supplies.

An Even Stricter View

We could take an even stricter view of the situation, and argue that our hypothetical worker's paycheck is mostly spoken-for by typical monthly expenses, leaving only a little for true "disposable income." Say, for instance, about 85% of his paycheck goes toward regular living expenses — mortgage, car payment, insurance, groceries, utilities, monthly savings, etc.

Then only 15% of his hourly earnings are truly available for extras, working out to about $3.90/hour of his $26/hour gross pay. If he's earning disposable income at $3.90/hour, those impulse purchases take up quite a bit of his working time to earn — almost **four hours** for the restaurant meal, **nine hours** for a $35 sweater, and more than **25 hours** to earn the "fun money" for the garden supplies!

The Importance of Perspective

Good spending habits are crucial for building long-term financial stability. Perspective can go a long way toward helping us make good choices. Take some time to pause — especially before making impulse buys — to put spending choices in perspective. ✸

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[1] Source: www.cbsnews.com/news/the-american-habit-of-impulse-buying/. Also https://www.psychologytoday.com/blog/the-science-behind-behavior/201607/does-it-matter-whether-you-pay-cash-or-credit-card

[2] Source: www.bls.gov/news.release/empsit.t19.htm. Data as of July 2017.

Five Ways to Spend (a Little) More Time on Your Finances

Most people do not enjoy spending time on their finances. One industry survey found that people spend more time choosing a restaurant than they do planning their IRA investments.[1] Another found that while 42% of people will take time to research every detail about an upcoming vacation, only 32% take time to research their retirement plan.[2] A third found that a majority of people spent five hours or more researching a new car purchase, but only 11% spent the same amount of time evaluating options for their 401(k).[3]

Investing is an easy thing to procrastinate on. Researchers have started to zero in on the reasons we put such things off, and increasingly, they're focused on how our emotions or moods drive us to put off particular tasks. "I'm not in the right mood for this now," we tend to think —"but maybe I'll be in the right mood to do it later."[4]

It doesn't help that managing your finances is the kind of task that gives you terrible feedback. You put aside some savings, invest in a series of things, and then you're not sure how to interpret the results — if your investments went up, did they go up as much as comparable choices? If they went down, is that because you chose the wrong thing? It's difficult to separate your own choices from the aspects of finance — like short-term investment performance — that are out of your control.

It's critically important for every household to have a plan for saving and investing, and make sure they're staying on track with the parts of their financial life that they can control — their own saving and investing activities. That takes an ongoing time investment. Here are a few ways to make time in your day to day.

Start with a tiny task that you like.

Count the cash in your wallet, or put stamps on the envelopes for your bills — whatever tiny task you most enjoy about dealing with your finances. Procrastination researchers find that even a very small "warm up" activity makes it easier to transition to the main task.

Block off some "set it up" time to get it over with.

Find an open hour or two on your calendar and make an appointment with yourself to do any "set up" work you may have put off — opening a new IRA account for your spouse, setting up auto-deductions in your account, whatever looms undone. Plan a special reward — a relaxing walk or a movie, perhaps — to celebrate finally getting it finished.

Try out different "check in" systems.

Look for a regular routine that can keep you checked in to your finances — maybe you log in to all accounts on Friday mornings, or put twenty minutes on your calendar the first day of the month to review your progress. It has to be a system that you find easy and enjoyable enough to stick to.

Connect with a friend.

We have a much higher success rate for sticking to a resolution if we do it with a friend. Consider pairing up with someone who also wants to establish better habits, and hold each other accountable for the time you commit.

Consider working with an advisor.

Professional advisors can help keep you on track, and offer advice. Our team of client service associates is always here to be a resource to you. Give us a call at 800-258-3030.

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[1] www.tiaa.org/public/about-tiaa/news-press/press-releases/pressrelease495.html

[2] www.poconorecord.com/news/20160611/retirement-planning-and-sunscreen---both-are-vital

[3] money.cnn.com/2014/08/19/retirement/401k-investments/index.html

[4] www.theatlantic.com/business/archive/2014/08/the-procrastination-loop-and-how-to-break-it/379142/

What Can You Expect from Your Investments?

Investing should be done with a hearty dose of fact-based knowledge, rather than gut instinct. How thorough is your knowledge of different kinds of investments?

Here we offer quick stats on how different investments typically behave. Understand that these are broad averages — no single stock, bond or house is expected to conform exactly to these profiles. But seeing how baskets of similar securities have performed over time can help you set more reasonable expectations for the range of returns you may experience.

STOCKS

Represented by the S&P 500 Index

12.6% Average annual return over last 40 years

Lowest 1-year return:
–43.3%

Highest 1-year return:
60.9%

Average annual return in the last 10 years:
8.9%

Risk:
Highly volatile from one period to the next

Easy to cash out?
Yes, most large publicly traded stocks and mutual funds are highly liquid

BONDS

Represented by the Bloomberg Barclays Aggregate Bond Index

7.6% Average annual return over last 40 years

Lowest 1-year return:
–9.2%

Highest 1-year return:
35.2%

Average annual return in the last 10 years:
4.5%

Risk:
Low or medium swings from period to period

Easy to cash out?
Yes, typically highly liquid

REAL ESTATE

Represented by the S&P/Case-Shiller U.S. National Home Price Index

4.9% Average annual return over last 40 years

Lowest 1-year return:
–12.8%

Highest 1-year return:
16.3%

Average annual return in the last 10 years:
0.4%

Risk:
Low or medium swings from period to period

Easy to cash out?
No, less-liquid

CASH

Cash is a little different because the dollar value obviously stays constant over time — but thanks to inflation, the purchasing power falls. We use inflation as a "negative return" for cash.

–3.5% Average annual decline over last 40 years

Lowest 1-year return:
–12.9%

Highest 1-year return:
1.9%*

Average annual decline in the last 10 years:
–1.7%

Risk:
Very low swings from period to period

Easy to cash out?
Yes, already in cash!

**indicates deflationary environment*

Sources: **Stocks:** FactSet. **Bonds:** FactSet. **Real Estate:** St. Louis Federal Reserve. **Cash:** Bureau of Labor Statistics.
Average returns quoted represent the average of rolling 12-month periods. ICONS © ISTOCK / BUBAONE

News Briefs

Website Changes Coming Soon

We're working to improve the shareholder section of homesteadfunds.com. By January 2018, you'll be able to log in to your account to:

- **Open a new account.** Save yourself some time and a stamp. You will be able to complete all of the paperwork online.
- **Establish or update bank instructions.** Bank accounts can be instantly verified to make adding bank instructions easier.
- **Automatically rebalance your portfolio.** Shareholders who allocate their assets to funds in specific percentages, will be able to rebalance back to their desired position on a quarterly, semi-annual or annual basis.

We'll send you more on the changes you can expect later in the year. And we always welcome your feedback on the website. Let us know what's working for you and what's not in an email to invest@homesteadfunds.com.

Find Us on Facebook

Homestead Funds has begun posting content regularly to this social media channel. Next time you're online, visit, like or leave us a comment. We look forward to connecting with you!

NRECA Regional Meetings

Homestead Funds staff are joining electric co-op leaders this October at the regional meetings taking place across the country. If you're attending, please stop by our booth and introduce yourself as a shareholder.

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. Bloomberg Barclays Aggregate Bond Index is a market value-weighted index that tracks the daily price, coupon, pay-downs, and total return performance of fixed-rate, publicly placed, dollar-denominated, and non-convertible investment grade debt issues with at least $250 million par amount outstanding and with at least one year to final maturity. S&P/Case-Shiller U.S. National Home Price Index tracks changes in the residential real estate values across the nation and in 20 metropolitan regions. An investment cannot be made directly in an index.

Homestead Funds' investment advisor, RE Advisers Corporation, and distributor, RE Investment Corporation, are indirect, wholly owned subsidiaries of NRECA. RE Investment, Distributor. 9/17

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