Horizons 2Q | 2016

A Quarterly Newsletter for Homestead Funds' Shareholders

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Sizing Up the Investment Climate

This spring was particularly soggy here in the Northeast. Just outside of Washington, D.C., where our investment team sits, it rained for an unprecedented 15 consecutive days in May. The previous record was 10.

An extreme blip in the weather is actually no big deal in this part of the country. Folks here know they can expect a wide range of weather over the course of the year, from blisteringly hot and humid summers to frosty winters prone to street-clogging snow storms. That's just the climate. As it turns out, climate is a particularly apt comparison for different investment types.

(continued on page 2)

Putting Time to Work in Building Wealth

The shops are full of graduation balloons, and the summer interns have arrived here in the Homestead and NRECA offices. It's an inspiring time of year, with a special focus on the young people in our lives.

Stephen Kaszynski, CFA
Director, President and CEO

When I think of the time that lies ahead of the younger generation, I'm reminded that time is one of the most powerful tools for building wealth, thanks to the force of compounding growth. One textbook example: an investment that returns 10% *doubles in value* every seven years. Doubles! The power of time is astonishing.

But to put the power of time and compounding growth to work, we first need to save. A sobering recent article highlighted just how few Americans are saving adequately. Not just for retirement, either; a full 47% of Americans wouldn't be able to come up with $400 in an emergency.[1]

As behavioral scientists are learning, humans are not well-wired for the habits of saving and investing. We tend to value the present more than the future. We fear $1 loss more than we enjoy $1 gain. We procrastinate. Yet, the stakes just keep growing. For each successive generation, the onus for saving and investing is even more squarely on the shoulders of each individual, as Social Security payouts are projected to decline and many employers shift away from defined benefit pension plans.

The good news is that today's young people know this. The millennial generation saves in plans like 401(k)s at much higher rates than the same age group did 10 years ago.[2] They're on the right track.

Contributing to your accounts is the first important step. The next step is to be an active participant in choosing your investments, and for that you'll need to understand the basics of investing, also known as financial literacy.

As your partners in building wealth, we offer a special focus in this issue on financial literacy and the active participation that you, our shareholders, can take to stay on the right track—and help the young people, the children and grandchildren, in your life. Let's look to the young people in our lives to remind us all to keep learning.

[1] Gabler, Neal. "The Secret Shame of Middle-Class Americans." *The Atlantic*. May 2016.
[2] www.cnbc.com/2015/10/19/gen-y-gets-an-a-in-401k-plan-participation-study.html

Five Minutes for Financial Literacy: Compound Interest Quiz PAGE 4

ESTABLISHED 1990

Homestead Funds

Knowing the Climate of Your Investments

Consider the difference between London, England, a mild marine climate, and Amarillo, Texas, a semi-arid climate. The average temperature of both locations over a year is about 55 degrees. But that average hides an important point: in London, it's *always* close to about 55 degrees. In Amarillo, 55 is the average because the climate is constantly zipping past that number, on the way up or on the way down. Averages are important, but *range* is a crucial piece of information too.

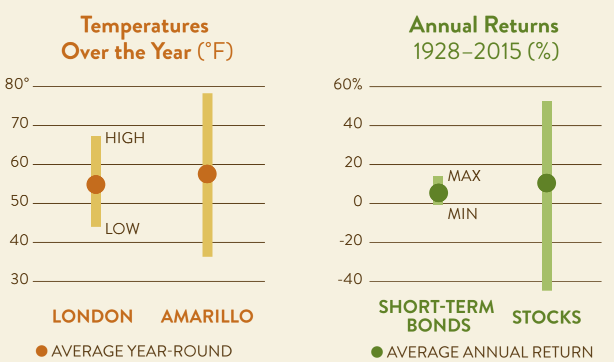
Perspective on long-term averages and ranges is also helpful in understanding investment types. Historically, stocks have had a high average return. But the range of what's normal, in terms of annual returns, is quite wide. Some years are extremely hot, while others are cold. Bonds, on the other hand, are more of a London kind of climate. Historically, bond returns don't vary as widely from year to year. *Past performance is not a guarantee of future results.*

Understanding the Seasons

Climate is also a good reference point when it comes to thinking of the seasonality of different investment types. Bonds are more like London in this way, too. In London, the average temperature doesn't change that much between winter and summer. Bond returns, a product of interest rates, tend to stay in certain zones for very long periods. This is due both to the structure of bonds, and because interest rates are so connected to monetary policy. If the Federal Reserve wants to keep interest rates low for eight years, it is quite able.

Comparing Investment Types to Climates

Bond returns have a smaller range, like London temperatures. Stock returns span a wider range, like the Amarillo climate.



Returns for bonds and stocks are averages for prior years.
Past performance is not a guarantee of future results.

Source (Climate): en.wikipedia.org/wiki/London#Climate; en.wikipedia.org/wiki/Amarillo,_Texas.

Source (Investment returns): people.stern.nyu.edu/adamodar/New_Home_Page/datafile/histretSP.html. Bond and stock returns represent calendar year total returns for the S&P 500 Index (stocks) and the 3-month U.S. Treasury bill (bonds).

Stocks, on the other hand, are more like Amarillo's seasons, where the temperature changes quite a bit across a full cycle. Instead of spring, summer, fall and winter, stock returns follow a bull market (periods where stock prices are climbing), divided into early, middle and maturing stages, followed by a bear market (a period where prices decline 20% or more). The cycle is never exactly the same length or magnitude, but it does follow these general phases. For the post-war period, the average stock market cycle has been about 5.6 years.[1]

The Old Investor's Almanac: Which Season Are We In?

Knowing that stocks are cyclical, like seasons, we have to ask: which season are we in now?

Stock prices have been climbing since the financial crisis of 2008-09—putting the market in its seventh year of bull territory. That may be a sign that we are in the late innings of the rising stock price phase.

And there are other markers to suggest a coming inflection point. Corporate earnings have been softening for more than a year, led by falling energy company profits but extending beyond the energy sector as well.[2] Likewise, corporate merger and acquisition activity has been at record-setting levels over the last two years or so.[3] This kind of activity usually coincides with the end of up-market cycles, as companies are flush with cash but struggling to find new growth opportunities.

But it's not that simple. Market cycles are incredibly hard to time, for better or worse. When we look for predictable patterns, we miss the bigger truth: every market cycle is different. Some only last two years, while the longest stretched on for nearly 10. And each cycle died of different causes, so to speak. The last bear market was caused by the housing bubble bursting, while the one before that started with plummeting tech company values. Do you know how many of the 13 post-war stock market cycles were exactly 5.6 years long? Zero.

Those of us here in the D.C. area are sure that spring comes before summer. But we don't know exactly which date summer weather will start, and sometimes spring looks a little weird; it rains for 15 days instead of the usual sunny heat.

Likewise, we can only assume so much about market cycles. With that in mind, it's easier to look outside at storm clouds, and remember that the only thing we know for sure is that they too shall pass. ✷

[1] Market cycles are based on price level of the S&P 500 Index. The end of a cycle is defined as the point where the S&P 500 Index declines by 20% or more. Data: www.quandl.com/data/YAHOO/INDEX_GSPC-S-P-500-Index.

[2] www.factset.com/websitefiles/PDFs/earningsinsight

[3] imaa-institute.org/statistics-mergers-acquisitions/

Financial Planning Q&A: Helping the Young People in Your Life

Helping young people develop an understanding of financial concepts—budgeting, investing and managing debt—can help them make smart choices that put them on a path to building wealth and creating a good quality of life for themselves.

How important is it to talk to children and grandchildren about money?

When we fail to teach kids about money, they can be woefully underprepared for all the decisions they have to make as soon as they strike out on their own.

What's more, studies find that even when we *don't* talk to children about financial decisions, they pick up on the symbolic value of money and all of the emotions it may stir up. They can carry those emotional associations into adulthood, instead of thinking about money in a logical way.[1] The best solution is talk to children rationally about finances.

What financial topics should I discuss with my children and grandchildren?

We seem most comfortable talking to children about saving, spending and earning money. But it's also important to give them good information about when and how to take on debt, and what goes into maintaining a good credit record, especially since such a high proportion will use student loans.

It's also crucial to make sure young adults understand the basics of investing. Research shows that parents are more likely to talk to boys than to girls about investing, although men and women play equal roles in managing household finances as adults.[2]

What are some ways to start those conversations?

Take the quiz. See if your child or grandchild can answer the financial literacy question on page 4 as a starting point.

Talk about the news. Keep an eye out for news articles or stories about things like student debt, credit mistakes or the rising cost of education. Share with kids and grandkids by bringing it up at the dinner table or emailing them a copy.

Ask about plans. As kids start to approach adulthood, ask if they understand the options to fund their living costs and bigger goals, and see if they have any questions. You may not know the answer offhand, but you can offer to figure it out together.

Young adults—anyone over the age of majority in their state of residence—can open and begin to fund accounts even with small amounts. Homestead Funds has very low investment minimums—$500 for a regular taxable account and $200 for an IRA or ESA. We waive our minimums entirely if you fund your account with regular investments made directly from your paycheck or bank account.

Gift a book. A well-written book on the basics of smart money management can arm kids with good information whenever they need it.

What are some ways I can contribute to my children or grandchildren's education costs?

There are account options available that provide tax benefits for education savings:

An **Education Savings Account (ESA), also known as "Coverdell" account**, is one great option. Savings in an ESA can be used for a wide range of eligible education expenses, from kindergarten through college. Investments grow tax-free, although distributions are taxable if not used for eligible expenses. Anyone can contribute, but the annual contribution limit is $2,000, and contributions are not deductible.

A **Uniform Gift/Transfers to Minors Account (UGMA/UTMA)** is another tax-advantaged option. This kind of account does not have annual contribution limits, although contributors are limited to federal gift limits ($14,000 for single filers or $28,000 for joint return filers) per year before triggering the federal gift tax. Investment earnings are taxed, but not at the same rate as a regular taxable account, so there are benefits.

Family members who have the means can also pay tuition bills directly without triggering the federal gift tax rules, and under specific rules, parents can withdraw from IRA accounts to pay for some eligible education costs.

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

[1] www.wsj.com/articles/the-smart-way-to-teach-children-about-money-1422849602

[2] www.sciencedaily.com/releases/2014/04/140429092549.htm

To learn more about education savings options, visit us at homesteadfunds.com and look for our guide on Saving for Education. Or call a client services associate at 800-258-3030.

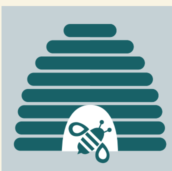
Five Minutes for Financial Literacy: Compound Interest Quiz

39% of Americans could not answer the below question about compound interest.[1]

Q: Suppose you put money in the bank for two years and the bank agrees to add 15 percent per year to your account. Will the bank add MORE money to your account the second year than it did the first year, or will it add the SAME amount of money both years?

A: MORE.
This is because the interest you earned the first year is now earning interest too, on top of the initial money you put in the bank.

Growing the Hive



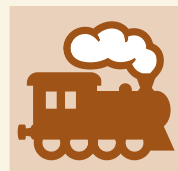
Think of each dollar that's invested as a worker bee. In this example, you start with 1,000 bees, and each bee earns you 6% per year (which is a good long-term estimate for after-tax returns in a portfolio of stocks and bonds).

After the first year, you've earned 6% additional bees—and now those new bees are going to earn 6% for you in each year that follows. So by year 10, you have 1,686 worker bees, all earning interest. By year 20, you have more than 3,000 worker bees.

Letting Time Do the Work

The longer your investment timeline, the more powerful this compound interest effect is. That's why you can save a lot less per month if you start early, yet still reach your retirement goals.

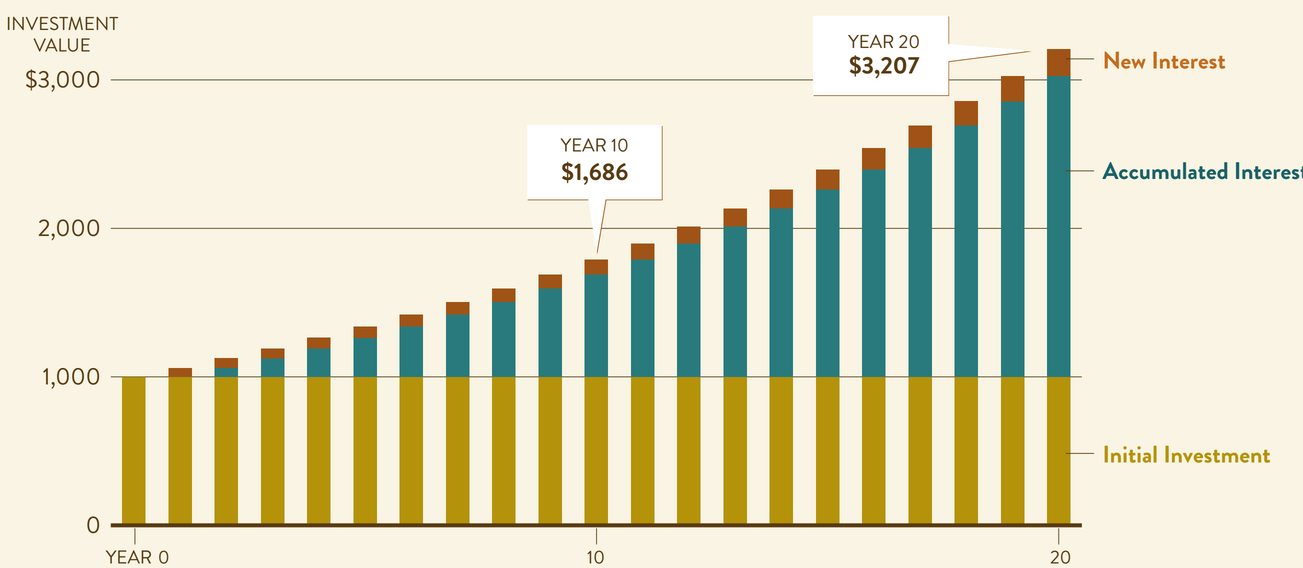
Growth that Gathers Steam



Compound interest has an exponential growth effect, where the growth rate gathers steam over time.

For instance, in this example, it takes **12 years** for the initial investment to double. But it only takes **7 additional years** to earn the next $1,000, **5 years** to earn the following $1,000, and **4 years** to earn the $1,000 after that.

How Wealth Grows: Hypothetical Growth of $1,000 over 20 Years at 6% Return



This is a hypothetical illustration provided for educational purposes only to demonstrate the mathematical principal of compounding. It is not a promise of any investment's future return.

[1] media.mhfi.com/documents/SandP_US_FINAL.pdf

Making Sure Student Loan Debt Makes Sense for You

My name is Allie Leake. I'm an intern for Homestead this summer. As a college student, I can attest, student debt is one of the most pressing issues on young people's minds. Below are some facts I wanted to share with you about student debt.

INVESTING IN YOURSELF

70%

of bachelor's degree recipients will have an outstanding student loan.

For 2015's graduating class, just over **70%** of bachelor's degree recipients will have an outstanding student loan.[1] Not all students stand to benefit from this investment.

College graduates typically earn more than those without a degree, so borrowing may make sense. But those who do not finish college may struggle to pay off their debts and they won't benefit from the income boost many graduates enjoy. People who attend community college or for-profit institutions are more likely to default on their loans than those at four-year colleges, another sign that not all loans are smart loans.[2]

MANAGING THE PAYMENTS

The typical borrower between ages 20 and 30 pays

$203

A MONTH

The typical borrower between ages 20 and 30 pays $**203 a month** toward student debt. Three-quarters of borrowers pay no more than $400 a month.[3] Meanwhile, the average total student debt of graduates in 2015 was a little over $35,000.[4]

The standard repayment plan for federal student loans puts borrowers on a ten-year track to pay off their debt, although it might take some longer. It takes an average of 14 years to pay student loans, based on an average starting salary of about $40,000.[5] Making payments larger than the minimum amount will get students out of debt sooner and decrease the amount of interest they are paying.

MULTIPLE DEMANDS ON DOLLARS

63%

OF MILLENNIALS MOVED HOME AFTER COLLEGE

According to a recent UBS survey, about **63%** of Millennials moved home after college with the number one reason being to save money.[6]

Young people with debt may find it challenging to manage multiple payments—like rent or a car payment—and may need to make different choices or defer large purchases. College graduates are still more likely to buy a home than those who did not attend college.[7]

[1] blogs.wsj.com/economics/2015/05/08/congratulations-class-of-2015-youre-the-most-indebted-ever-for-now/
[2] www.nytimes.com/2015/09/11/upshot/new-data-gives-clearer-picture-of-student-debt.html?_r=0
[3] blogs.wsj.com/economics/2016/05/24/how-much-are-young-americans-paying-a-month-on-student-debt-less-than-you-think/
[4] blogs.wsj.com/economics/2015/05/08/congratulations-class-of-2015-youre-the-most-indebted-ever-for-now/
[5] business.financialpost.com/personal-finance/student-debt-average-payback-takes-14-years
[6] nypost.com/2016/05/14/college-grads-are-moving-home-for-help-from-mom-and-dad/
[7] www.washingtonpost.com/news/grade-point/wp/2016/05/04/student-debt-is-actually-not-holding-back-the-housing-market-says-economist/

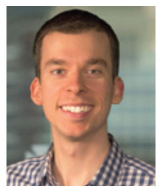
News Briefs

Asset TV: Mark Ashton Discusses Opportunities for Small Caps

Small-Company Stock Fund co-manager Mark Ashton was one of four panelists who participated in an Asset TV roundtable on small-cap investing. Visit homesteadfunds.com to see excerpts from this discussion, videotaped April 13, 2016, where Mark talks about the team's approach to stock selection and view of opportunities in the small-cap space.

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, financial resources or their management teams may have less depth and expertise compared with large-capitalization companies.

Welcome New Faces



Mauricio Agudelo joined as a fixed-income portfolio manager in April. He joins senior fixed-income portfolio manager Doug Kern in co-managing RE Advisers' bond strategies. **Rachel Rosenberg** is the company's new marketing coordinator. Before joining Homestead Funds, she worked for the company's parent organization, NRECA. **John Scott** is our newest client services associate. He and others on the team provide information to help shareholders understand and work toward meeting their financial goals.

We are also pleased to have **Allie Leake** with us this summer. Allie is taking a break from her studies at University of North Carolina at Chapel Hill where she is pursuing a double major in media and journalism and economics with a specialization in public relations. Allie authored the story on student debt that appears on page five of this issue.

Homestead in the Co-Op Community

Homestead Funds will be attending this year's INTERACT conferences, kicking off July 23 in Portland and repeating on August 13 in Indianapolis. We'll also be on-site at NRECA's Tax, Finance & Accounting Conference for Cooperatives starting July 31 in Washington, D.C. NRECA Regional Meetings kick off in the fall and we'll have staff onsite. If you are attending any of these NRECA events, be sure to take a minute to visit Homestead Funds.

Homestead Funds was created for the rural electric cooperative community, but you don't have to be a co-op employee to invest. Family and friends of NRECA member system employees and the general public can open accounts.

We have very low investment minimums—$500 for a regular taxable account and $200 for an IRA or ESA.

Past performance does not guarantee future results.

The views expressed are those of the individuals as of June 7, 2016 and may have changed since that date. The opinions stated may contain forward-looking statements and may discuss the impact of domestic and foreign markets, industry and economic trends, and governmental regulations of the funds and their holdings. Such statements are subject to uncertainty, and the impact on the funds might be materially different from what is described here.

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

Investors are advised to consider fund objectives, risks, charges and expenses before investing. The prospectus contains this and other information and should be read carefully before you invest. To obtain a prospectus, call 800.258.3030 or visit homesteadfunds.com.

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NRECA America's Electric Cooperatives