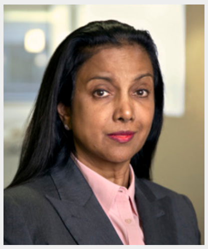
Our Perspectives: Value Investing Returns to Favor. We've Been There All Along.

Homestead Funds



Prabha Carpenter, CFA®

Senior Equity Portfolio Manager

Prabha co-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.

For years, financial news media, institutional allocators and other investors have mused about whether value investing as we know it is broken. Institutional Investor magazine went so far as to declare value investing dead in 2008, in the early stages of the development of a mighty bull market that stampeded out of the Great Financial Crisis. But now, the word you see many market participants associating with value stocks is "comeback."

The equity team at RE Advisers, investment advisor to the Homestead Funds, has been solidly in the value camp since the company's start in 1990. The team's traditional approach to value investing has consistently focused on rigorous analysis while evolving to make use of new technologies and the insights and expertise of new team members.

Here we interview senior equity portfolio managers Prabha Carpenter and Jim Polk to get their thoughts on why value investing is back in vogue today – and why we believe value stocks should always have a place in an investor's portfolio.

Q: Can you provide some context for the resurgence of value investing?

JIM: In our view, the tide has turned out of the recovery from the COVID-19 pandemic. The response to the 2020-21 period of upheaval was unprecedented, with the U.S. government providing a historic level of fiscal stimulus as the Federal Reserve maintained easy monetary policy to make markets and the economy as stable as possible while the virus took its toll on the world. Americans, many now vaccinated against COVID-19, are emerging from nearly 15 months of shelter-in-place orders with cash to spend. This tremendous release of pent-up demand is driving up prices at the gas pump, at the grocery store and in the housing market. Though we at Homestead Funds share the Fed's view that this will prove to be transitory, rising inflation is piquing investor interest in value stocks, as these companies have strong cash flow in the near term.

We believe that investors who always keep a portion of their assets in value stocks — or better yet, in a diversified fund of high-quality value stocks — will be better positioned than those who are piling into performance trends now.

PRABHA: We look at value investing through a long-term lens. Speculation persists among those investors who are trying to time the market and figure out how long "value's comeback" will last. But this short-term mindset defies what we at RE Advisers believe is the true, modern meaning of value investing: conviction in a company's management, its financials and the ability to compete in an ever-changing world. Buying a "cheap" stock based simply on low price-to-earnings multiples or price-to-book ratios and anticipating a bounce back to historic norms is not what we believe is a sound investment strategy.

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Q: As you think about the next phase of the economy's recovery, what sectors might be poised to outperform?

PRABHA: We believe the COVID-19 recovery has and will continue to benefit companies historically deemed value stocks. With the faster-than-expected pace of the economy's comeback driving inflation upward, the Fed will be under pressure to raise interest rates. If the economy continues to grow at a fast pace, then businesses will need to invest. Financial stocks are poised to benefit, as corporate spending will drive loan growth. According to S&P Global, the financial sector was up approximately 25.14% year-to-date as of July 30, and it is the Homestead Value Fund's second-largest sector weight at about 20% of the portfolio this year through June 30. **JPMorgan Chase & Co** is one of our top holdings because it exemplifies a true modern value investing play now – a quality company that is not only undervalued at present but also historically consistently profitable with favorable growth prospects and a historically strong balance sheet.

Q: At midyear, the Value Fund's portfolio is underweight the energy sector relative to its benchmark, the Russell 1000 Value Index. So your view of opportunities in that sector emerging from the pandemic is different?

JIM: Yes — We would place the COVID-19 rebound trade in the energy sector on the opposite end of the quality-value spectrum. This is the best-performing sector so far this year; according to S&P Global, the energy sector has returned 33.08% year-to-date through July 30. Value investing trend-followers rushed in, enthused by people using oil and gas as they traveled and resumed social activities that were sidelined by the pandemic. A pickup in industrial demand also helped prop up the industry.

But we believe the investor enthusiasm for energy stocks in 2021 represented an overreaction to positive, albeit potentially fleeting, news. There may be price support in the near term, but the supply and demand dynamics are less favorable over the long haul. Contributing to our generally low expectations for the sector: We see a decarbonized future centered on renewables, and public energy companies having historically been poor allocators of capital. Changes in technology and governance measures have destroyed mean reversion in many industries, including energy.

As a caveat, I would say this is a dynamic sector undergoing a transition and ultimately that could spur innovation and change the outlook for the sector considerably.

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Q: What's the story for health care, which as of June 30 was the Value Fund's largest sector commitment?

PRABHA: The health care sector has only returned 17.33% year-to-date through July 30, according to S&P Global, yet we know from our experience through the pandemic how important these companies are to the world moving forward. One of the top holdings in the Homestead Value Fund, **Abbott Laboratories,** was an early creator and provider of COVID-19 tests. The dip in its stock price as vaccinations have risen and test demand has dropped has created a quality bargain. We believe this company is going to invent innovative devices and medicines for an aging population for years to come. As we see it, investors focused solely on buying stocks that stand to benefit from the reopening of society are missing opportunities born out of long-term secular trends.

Let me also make an important point about active management here. Many passive managers of value funds are forced to own stocks based on a predetermined index. In contrast, active stock investors like us have more flexibility to analyze and assess the long-term viability of companies — and therefore, more opportunity to potentially capitalize on opportunities and avoid future pitfalls. For more than 30 years, we have held firm that active management is essential to value investing, as it allows you to dig deeper into companies' fundamentals and understand them in ways that passive managers simply cannot.

Q: The turbulence of the COVID-19 pandemic has taught us that circumstances can change almost instantly. Against such a volatile backdrop, what would you say is the overarching challenge for investors?

JIM: Now is not the time to be a passenger along for the ride of trends that could shift course at any moment. As long-term investors, we must turn down the noise and try to prognosticate how a company might compete years rather than quarters from now. It does not matter if you call this approach quality, modern or just plain value investing. Funds that buy stocks with both durable earnings power and reasonable valuations should always play a role in your portfolio.

Interested in speaking with one of our associates about your long-term investment plan? Call us at 800.258.3030, option 2.

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