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Q2 2020 Market Review: Massive Support Cushions the Blow

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Mark Santero: Thank you for joining the Homestead Funds second-quarter market review. I'm Mark Santero, and I'll be the moderator of today's presentation. With me, I'd like to introduce Mauricio Agudelo and Jim Polk, both senior portfolio managers with the Homestead Funds, who will be giving the majority of the presentation today. Let's walk through what the agenda will be. First, we're going to discuss the macroeconomic conditions and factors that we faced in the second quarter. Then we're going to go over the funds' absolute and relative performance, and their drivers of return. Then last, we'll discuss the outlook and fund positioning for the future. So without further ado, I'm going to turn it over to Jim Polk who's going to start with the equity markets.

Jim Polk: Mark, thank you very much. And thank you everybody who is joining us on this call. I think we can't really talk about the second quarter before thinking about the first quarter briefly. The first quarter, the economy was fine. And then we were hit with this pandemic. There was a complete shutdown of the economy that was absolutely unprecedented, and the market reflected that.

There were some other things going on as well. There was a lot of leverage in the market that got unwound as well in the first quarter. So as we went into the second quarter, you saw a couple of things happen. One was you had an unprecedented monetary and fiscal response that I think lent support that the government was doing all they could do from a fiscal and monetary standpoint to help the markets and the economy. And then you also had a situation where the market, which is a forward-looking mechanism, began to price in the fact that the second quarter would actually be potentially a trough in economic activity. And so again, looking forward, the market started to rebound. For what it's worth, as the equity team has begun to listen to conference calls and companies have been reporting, we've actually started to hear that from companies, that things have actually started to get better.

And with that, I would turn it over to Mauricio for some thoughts on the fixed-income market.

Mauricio Agudelo: Thank you, Jim. Very insightful on the equity side. The fixed-income market performed quite well during the quarter. As you mentioned, the fiscal and monetary support to the economy was very beneficial during this period. More importantly, the facilities put into place by the Federal Reserve (Fed) to provide adequate liquidity at a crucial time are yielding great results. One of these facilities, the secondary corporate bond buying program, began purchasing bonds in the secondary market in the month of June. We surpassed the one trillion mark of new issues by corporations in the month of May. This happened last year by close to the end of October. So, we definitely saw record amounts of issuance, as corporations were looking to increase liquidity and shore up and get ready ahead of what's to come, potentially, during the quarter.

That being said, credit spreads continue to perform well, and that's a sign of a healthy progression in the market and a sign of relief, and a vote of confidence overall to corporations and their credit worthiness going forward.

Mark Santero: Great. Thank you, Mauricio. Thank you, Jim. Now this time, let's keep Mauricio on the mic here and go over the portfolios on the fixed-income side. Mauricio.

Mauricio Agudelo: Yes, Mark. The performance for the quarter, for the Short-Term Bond Fund — we definitely had a great quarter. There was a rebound from what we saw in the first quarter. We have outperformed the benchmark by 1% for the quarter, and then that brought the overall year-to-date performance ahead by 31 basis points for the fund.

Now what worked during the quarter for the Short-Term Bond: We shifted to overweight corporates at the end of Q1 and we continued buying throughout the second quarter — industrials/financials corporates leading the way. Credit has been in the driver's seat. Additionally, our allocation to asset-backed securities (ABS), which detracted from performance in the first quarter, came back to be a positive contributor in the second quarter.

Now what didn't work: our underweight allocation to Treasuries. Currently, as Treasury yield reached near all-time lows, we shifted some of our Treasury holdings to corporates; this is our funding mechanism and asset allocation decision. Also, our underweight allocation to agencies detracted from performance during the period.

Taking a look at portfolio positioning, I want to highlight that we remain overweight corporates: The front-end, five-years and in is well supported currently as the Fed is actively involved in buying corporates in this part of the curve. We are also maintaining the portfolio duration relatively close to the benchmark by historical standards.

For the Intermediate Bond Fund performance, what worked during the quarter? In similar fashion to the Short-Term Bond Fund, we are overweight in industrials and financials, which led the way. Again, credit has performed very well. And, while we are not at pre-COVID levels in spreads, the market definitely appears to be heading that way.

Now what didn't work? We are underweight Treasuries and underweight agency mortgage-backed securities (MBS). Frankly, there's an asset allocation decision at the sector level where we see better risk/reward in other sectors — as I mentioned above, industrials and financials, in particular, as we are near all-time lows in Treasury yield. In terms of portfolio positioning, for the Intermediate Bond Fund, we remain overweight corporate and underweight Treasuries and agency MBS for the reasons that I just mentioned, while duration is slightly shorter than the benchmark, given the overall historical load in Treasury yield. That being said, we are constantly monitoring future developments that may shape the path for interest rates going forward.

Mark Santero: Great. Mauricio, thank you very much. Now I'm going to turn it over to Jim to talk about our two equity funds. Jim, the Value Fund please.

Jim Polk: Great, Mark. Thank you again. The Value Fund was up 16.3% and was ahead of its benchmark, the Russell 1000 Value, by two percentage points. Basically, big picture, as we mentioned at the beginning, in the second quarter it was really the more cyclical groups that outperformed. It was basic materials, consumer discretionary, energy that were all the big outperformers. And while we had less exposure to these groups than the benchmark, which actually detracted from performance, we continue to be significantly overweight in technology, which actually also performed very well in the quarter, and as a group, it was up about 19.5% and actually drove most of the outperformance in the quarter.

Tech has actually proven to be far more resilient and defensive in this downturn than I think many investors would have thought. Some of that I think is due to maybe better growth prospects. Some of it's probably due to the significant free cash flow generation that we're seeing. And some of it could actually be due to potentially longer-term secular themes that were created by COVID, such as working remotely. The counter to the cyclical groups doing well, by the way, was that defensive groups like staples and utilities actually underperformed. So they outperformed in the first quarter and then they underperformed in the second quarter. And we've been underweight those groups in general because we actually think there's better risk/reward in technology and health care, and we don't think they're that cheap, so we think we can find better values elsewhere.

Over the quarter, DuPont, which is a specialty chemical manufacturer; NVIDIA, which is a semiconductor chip manufacturer for both gaming and data center; and Stanley Black & Decker, which most of you know, is a maker of tools and obviously benefiting from stay at home, were up 57%, 44% and 40% respectively.

And you can see in our top 10 holdings that tech and health care make up a significant percentage of that top 10. And then obviously from a sector weighting, as I said before, health care and tech we believe are good, both from an idiosyncratic risk and from secular drivers that we want to be exposed there going forward.

And then finally, if you look down at the bottom at the metrics of the portfolio, what you see is what we strive to do, which is basically, for a comparable multiple to the benchmark, we think we're providing companies that are faster growing and that are of higher quality, as defined by better returns on capital or returns on equity.

So now if we go to the Small-Company, for the second quarter, we were up 20.4% versus benchmark, which was up 25.4%. But if you look at it for the full year, we're actually above the benchmark by a little bit over 5% for the year to date. So a very good quarter, and actually a very solid second quarter, despite the big snapback.

As with the Value Fund, we really saw a snapback in the cyclical sectors. It was energy and consumer discretionary, which were big sectors. So, it was a real risk-on trade with higher beta stocks outperforming. And in the Small-Company Fund, our bias for lower volatility, higher quality, higher market cap names is going to lead to some underperformance in a quarter like we saw in the second quarter. But again, for the year to date, we're 500 basis points-plus over the benchmark. And, in the second quarter, STARR Surgical, which is a maker of implantable lenses for nearsightedness and actually has a bulk of their sales in China; Floor & Décor, which is a specialty retailer, which like Stanley works as benefiting from stay at home and exposure to housing; and Callaway Golf, which is a leading manufacturer of golf clubs and apparel, were up 91%, 80% and 71% respectively. So it was that kind of a rebound quarter.

Like the Value Fund, both tech and health care represent big positions, big representations, in the portfolio. Again, we think they're really good secular drivers; we think they're great. There's better idiosyncratic risk in those sectors and we've funded that, if you will, by being underweight staples and utilities, which we think have less of those characteristics that we want. From a valuation perspective, the last thing I would touch on is, yes, we are more expensive than the benchmark on a price-to-earnings (P/E) basis, but we think it is warranted by owning these faster-growth, higher-quality names in the small-cap space.

And with that, I would turn it back to Mark.

Mark Santero: Thanks, Jim. I appreciate your update. Mauricio, thank you as well. So, I know with everything going on in the world, with this COVID-19, we've got China disputes, we've got an election — a major election coming in three months — there's a lot of concern about what's ahead. So, with that, I'm going to ask the two of you to talk about what you see ahead for both fixed-income and equity and how that might affect the portfolios and how we're positioned. So let's start with you, Mauricio. What do you see in the fixed-income markets?

Mauricio Agudelo: Yes, Mark. Our expectations are for the Fed's and monetary policy to remain highly accommodative, for fiscal plans to continue to support small businesses. We are mindful that we are certainly not out of the woods until a vaccine or multiple vaccines are in place to take care of this pandemic. We expect pressure in yields to remain low with the front end, especially anchored at current levels. I want to highlight here that we had a great opportunity to buy corporates at very attractive levels — levels that we have not seen in the last 10 years, basically, overall as a whole, for the investment-grade corporate market. We expect credit spreads to continue marching and eventually getting to pre-COVID levels.

Our conviction is supported by continued support from the fiscal and monetary side, and less issuance by corporations in the second half of 2020, which provides a positive technical; and last, but not least, every day that goes by we get closer to development and distribution of hopefully multiple COVID vaccines. We foresee corporate credit to be the primary driver of returns in fixed income. However, we are cognizant of the downside risk to any resurgence in COVID cases and the U.S. presidential election and relations with China, as we've seen lately. We will remain vigilant and we will remain active.

Mark Santero: Thank you, Mauricio. Jim, you don't have a slide, but I know you're never short of opinions, so why don’t you share with us what you see ahead for the equity markets as it relates to our portfolios.

Jim Polk: Sure. I would echo what Mauricio said as far as our expectation is that there'll continue to be a highly accommodative Fed. And I believe Congress is now working on their fifth stimulus package that will get passed. So, we do think that, call it a back stop, that there will be both Fed and fiscal — monetary and fiscal — policy. And I also agree that the vaccine is a game changer, right? If we get it, it will be an absolute game changer. It will take time, but there is a tremendous amount of brain power and money being spent on that. So we, as a team, are cautiously optimistic, but it remains to be seen.

We think the wrestling point for the market right now, in the interim, is what does the “E” in price earnings stand for? What’s the true number, because people are really struggling with that. We've had this big bounce back in the second quarter. And as we look forward, it's hard to get a sense of what the real earnings of the market are going to be and therefore what kind of multiple to put on that. So, we think there will be more volatility in the market as the pace of reopening then recovery and talk of vaccine, etcetera, continues to hit the airwaves, right? I think a lot of that is we've seen states now starting to shut down again. So we think it's going to be lumpy. We're not here to call whether it's going to be a V-, U-, L- or W-shaped recovery, but we just expect that there will be some volatility.

The thing that we've been saying for the last several quarters is that in the absence of a real business cycle, of a true business cycle, we want to be positioned in those sectors that have better growth prospects that can deliver revenue growth and earnings in a world or in an economy that has a dearth of those. And so that has led us to lean into, as I said before, into technology, into health care in particular, as sectors that from a big theme standpoint we want to be involved with. However, as I said, there is going to be this volatility in the market, and we want to be opportunistic. And we want to look for names that have been unduly beaten up, of good companies where we think we can get them at reasonable prices. We have made some additions in the second quarter, particularly on the retail side, and we will continue to be opportunistic going forward.

And with that, Mark, I would turn it back to you.

Mark Santero: Great, thank you both for your time. I want to thank all of our shareholders for your continued support of the Homestead Funds. We are in unprecedented times, and we hope everyone is safe and we hope everyone is well. What I also want to offer is if you do have questions, please either call me or send me an email, and we will immediately get back to you, either myself or Jim or Mauricio or one of our other investment professionals. We're always here for you, and I just want to make sure that you get our materials; you look online. We do have a lot of updates; we do have a lot of material for your edification. So please don't hesitate to go online, www.homesteadfunds.com, and look at all the materials that we have. So, with that, we thank you for listening, and we hope everybody remains safe and well. Thank you.

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

Beta is a measure of a stock's volatility in relation to the overall market.

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.

Multiple measures some aspect of a company's financial well-being.

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

V-shaped recession is when the economy suffers a sharp but brief period of economic decline with a clearly defined trough, followed by a strong recovery.

L-shaped recession occurs when an economy has a severe recession and does not return to trend line growth for many years, if ever.

U-shaped recession is longer than a V-shaped recession and has a less-clearly defined trough.

W-shaped recession happens when the economy falls into recession, recovers with a short period of growth, then falls back into recession before finally recovering.