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Q4 2020: Vaccine Fuels Healthy Finish for Investments

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Mark Santero:
Thank you and welcome to the Homestead Funds fourth-quarter market review — very interesting topic, Vaccine Fuels a Healthy Finish for Investments.

I'm Mark Santero, and I'll be your moderator today. And I appreciate, as always, the opportunity to share with you our views on not only what went on in the fourth quarter but what we see going ahead.

And with me today are two of our senior portfolio managers: Mauricio Agudelo, our head of fixed income, and Jim Polk, our senior equity portfolio manager. I appreciate the two of them sharing their views with our investors.

So what are we going to cover today? Basically we'll run the same format as always. We're going to cover the macroeconomic conditions and factors. We'll talk a little bit about the funds' absolute and relative performance. We'll look at the drivers of returns, and then we'll end with our outlook and fund positioning.

So, let's get started. Let's talk about the fourth quarter. Jim, why don't you take us away?

Jim Polk:
Great. Thanks, Mark, and welcome everybody. Well, if the fourth quarter capped an unprecedented crazy year, big picture, you had what we thought was going to be a muddle-along kind of, at the start of the year, economy. And then obviously we got thrown into this pandemic, and the markets reacted. What you saw in the fourth quarter was in some ways a continuation of what you saw in maybe the second and third quarters, to some extent. You had a Fed that remained very accommodative and very easy monetary policy — and I'm sure Mauricio will go into more detail about that. You also had fiscal stimulus coming that was throwing everything they could at it. So in the fourth quarter you had the Fed, you had the fiscal, you had vaccinations that were now being introduced, and people started getting more and more optimistic. And then you had an election, which was controversial but you got it behind you. So there was some resolution there, and markets hate when things are not more clear. And so getting that stuff behind us — whether or not there was going to be a vaccine and the election — was all positive.

Clearly there are some industries that are being hurt, but even they are getting better. The energy sector has started to rebound. Anecdotally people want to get back out and either go on cruises or vacations or to restaurants. So there's more optimism, and that was being felt in the fourth quarter despite COVID numbers going up, and that was starting to get better. And so the equity markets reflected that. The equity markets had a positive response to these sort of positive things that were going on.

And with that, I turn it over to Mauricio to talk about the fixed income markets.

Mauricio Agudelo:
Thank you, Jim, absolutely. On the fixed income side, the bond market followed a similar path as the equity market, in terms of the recovery. During the quarter, the bond market posted another strong quarter to finish a pretty strong year overall. Five years and in, U.S. Treasury yields remained anchored near the Fed's zero target, while longer-dated Treasury yields — those maturities with 10 years and out — aged a little higher, and that's in your comment about how the Fed remain very accommodative to support the ongoing recovery.

The environment for corporate credit remained very robust. Credit spreads, which are the difference between corporate yields and Treasury yields, continue to compress — in fact by one measure, which is the Bloomberg Barclays Corporate Credit OAS [option-adjusted spread], finishing at pre-COVID levels. So credit spreads pretty much did a round trip throughout the year, finishing flat at the end of 2020. The amount of liquidity and support provided by the Fed and the boost provided by the development of the two vaccines that were approved for emergency use at the end of the year gave investors further visibility into the ongoing recovery.

And finally the credit market saw less issuance of new corporate bonds versus the prior two quarters. This backdrop also provided a positive technical for credit spreads.

And with that, let me turn it back to you, Mark.

Mark Santero:
Thanks, Mauricio, and thank you, Jim. It's important to look back and see how the funds performed in light of what we just went over as the markets behaved in the fourth quarter. So let's talk about our fixed-income portfolios first, and I'm going to turn it back over to Mauricio to start with our Short-Term Bond Fund.

Mauricio Agudelo:
The Short-Term Bond Fund was 0.82% in the quarter performing its benchmark, the Bank of America 1-5 Year Corporate/Gov Index, which returned 0.37%. For the calendar year, the fund outperformed the benchmark as well: 5.42% versus 4.65%.

Now what worked during the quarter? Our corporate bond holdings in the financials and industrials sectors aided relative returns. The ABS [asset-backed securities] sector, which basically is consumer loans and auto loans, on our part, was another positive contributor to performance.

Now what didn't work? Our underweight allocation to sovereign and supranational sectors where we have zero exposure. We don't really see a ton of value in those sectors, and that detracted from performance.

If we turn to the next slide, the fund remains very well diversified with an overweight allocation to the corporate and the ABS sectors while we are underweight Treasuries at this point in time.

Now turning to the Intermediate Bond Fund. The fund returned 1. 51% in the fourth quarter, outperforming the benchmark, the Bloomberg Barclays Aggregate Bond Index, which rose 0.67% — a really strong quarter for the Intermediate Bond Fund, which contributed to our performance for the year about 8.7% versus 7.51% for the benchmark.

Now what worked during the quarter? In a similar fashion to the Short-Term Bond Fund, our corporate bond holdings in financials and industrials helped returns. Additionally, the municipal sector added to our relative performance. We started to become quite active in the taxable muni space in the fourth quarter as we saw new issue opportunities there.

Now, what didn't work during the quarter? Our underweight allocation to sovereign and CMBS [commercial mortgage-backed securities] sectors, where we had no exposure — that detracted from performance.

Next, the fund is very well-diversified with an overweight allocation to corporate and the ABS sectors while we are underweight in Treasuries and MBS [mortgage-backed securities].

And finally the fund's duration ended the year relatively close to that of its benchmark. And that's the recap for the fixed-income funds.

Mark Santero:
Thank you very much, Mauricio, much appreciated. I'm going to turn it over to Jim to discuss the two equity portfolios.

Jim Polk:
If you look at the performance numbers, we slightly underperformed the benchmark in the fourth quarter. But what I call your attention to is the fact that the fund and the benchmark were up in the mid-teens in terms of performance for one quarter, which we're pleased with that. But that just goes back to what both Mauricio and I were talking about before — just the tremendous stimulus that was happening in the quarter.

So the Value Fund was just about 14.8% — and probably in a similar fashion to the fixed income portfolios, it was really more the cyclical sectors that worked. Groups like energy, financials and industrials led the way. For us, it was really driven by long-term holding, top 10 names, like Honeywell, Avery Dennison, Parker Hannifin, in the industrials and materials space, and our lack of energy exposure is kind of what hurt us.

If you look down at the portfolio metrics, you can see that we tend to be overweight health care and tech, two sectors that we really believe have long-term secular trends. Tech with things like artificial intelligence, automation — health care's got demographics, new drugs — so we really like to be there. So if you have a quarter or even a couple of quarters where it's going to be really cyclically driven, there's a potential to lag there. But we also do barbell that with more cyclical exposure, just a little bit less. So we do have overweights in industrials and materials. And although optically we are underweight financials, we are actually overweight banks.

One last thought on that is just a reminder that our philosophy really is that over time, a portfolio comprised of higher-quality stocks with reasonable valuations will outperform the market. And what you saw in the fourth quarter was really a lot of that rebound trade — so a lot of lower-quality names, a lot of cyclical names — so we're just not as exposed there.

If you turn to the Small-Company, the story was really the same. It was a quarter that when you look at the Russell 2000 benchmark, it was up 31% in the quarter and we were up 22%. Really good absolute performance. And when you look at it for year to date, we outperformed, although we did underperform in the quarter. Unlike the large-cap, some of this was really driven by stock selection, which is not atypical — let's put it that way — it's not atypical in any given quarter for some volatile, single stock returns. Same sort of macro overview and same exposures. We really like the health care space; we like the tech space for the longer term, secular reasons. We do have a good weighting in cyclical names, but more so in the Small-Company product fund than the large strategy. Again, any given quarter could be plus or minus based on some stock picks. Some of the stocks in our health care sector, like Twist Bioscience and NanoString and STAAR Surgical, were actually up over 40% in the quarter.

We have that barbell approach that we have in the value strategy. Secularly, we really do like health care and tech and higher-quality companies. And with that, Mark, I turn it back to you.

Mark Santero:
Thanks, Jim. And thanks again, Mauricio. One thing I think is important to note: 2020 by everybody's account was one of the most bizarre, crazy years that we've all experienced, and I think we can honestly say we hope we never do again. We had four market reviews, and I think that we've had four different economies present in 2020 if you look at how each quarter performed. And we just reviewed the fourth quarter, which was a strong quarter in a pandemic that's a lot of rebound trades and credit availability.

What's most important, though, is every portfolio that we reviewed today — the two on the fixed and two on the equity side — over the course of 2020 outperformed their benchmark. Which again, when you think about 2020 and having four economy cycles in one year, it's a testament to our investment management expertise that over the course of those four volatile quarters, we outperformed our benchmark. So great job by the investment team.

Enough about what happened in the past. What's going to happen going forward? I will say that if you go to our website, homesteadfunds.com, we do have our market outlook, which goes into a little greater detail on what's ahead. But it wouldn't be a quarterly review if we didn't ask our PMs [portfolio managers] to talk about their views on the opportunities going forward. So I'm going to turn it back over to Mauricio to cover opportunities in the bond market for '21.

Mauricio Agudelo:
Yes, Mark. To our audience, I'd like to point to this chart, which basically reflects the level of credit spreads relative to the five-year U.S. Treasury yield.

And as we highlight here, 2020 was certainly an opportunity for active management. And that's what we strive to provide day in and day out for our investors. We certainly capture those opportunities that became available.

Now credit spreads, as I mentioned before, have come back to a pre-COVID level. Yet we still see a lot of potential in corporate bonds at this point — financials and industrials — and that is reflected in our positioning, given the ratio overall of the yield that's offered by corporate bonds versus the respective Treasury at that point. And also this is supported by the accommodative stance of the Fed.

So on the monetary front, we expect the Fed to remain on the sidelines. Rates will be anchored near zero in the front end. The new administration is already taking steps to provide more fiscal stimulus to support and aid the ongoing economic recovery.

It will be very dynamic, and we see a lot of value in corporates. Outside of corporates, we see value in ABS. Like I mentioned before, consumer loans and auto loans — those are two segments of the ABS market where we have high conviction. And last but not least, the taxable muni market is certainly providing a lot of opportunities for our investors, and we are certainly digging through those constantly.

With that, let me pass it along to Jim to give us an outlook on the equity markets.

Jim Polk:
Thanks, Mauricio. I would look at this chart and go, it's working, right? The Fed's accommodative policies, fiscal policies, are showing that there's projected growth in the economies — in worldwide economies, in the U.S. economy. And so we think that with the Fed's accommodate stance, you've got a potential fiscal bill of current

estimates around $1.9 trillion. There's talk of student loan debt being relieved. So you've got a lot of momentum building in the economy. As I said before, people want to get out. Household savings are up year over year. There's a lot of pent-up demand in the economy, which makes us cautiously optimistic because there are a couple of offsets to that. One is valuations aren't super cheap, so we want to be careful, and we have a long-term focus, so we want to be a little careful about allocating capital. So we're sifting through stuff, both on the large side and on the small-cap side.

The second thing that's going on in the market that I want to touch on briefly is that GameStop* phenomenon that's been occurring, where you're getting these speculative traders and day traders who are jacking up the prices on a lot of these left-for-dead companies. Certainly in the back of our minds, obviously a little bit of speculative fever there, because some of these prices are clearly disconnected from the fundamentals of these companies. That is something that we stay away from — we are longer-term investors — but it does represent some speculative fever in the market that we want to be leery of. And I would echo Mauricio's comments about active management, not being sucked into that vortex and chasing those sorts of things. And again, that could hurt you in any given quarter, but we think over time, being exposed to higher-quality companies with good fundamentals is the way to win.

Mark, I turn that back to you.

Mark Santero:
Great. Thank you, Mauricio, thank you, Jim, for giving us a little bit of what happened in 2020, and most importantly, what we see in ‘21. I want to thank all our shareholders, all our investors, for supporting the funds. If you require any information or have any questions, please send me an email or give me a call. That's my direct line and that's my email. We're here to help in any way we can. So thank you for listening and have a wonderful day.

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