Quarterly Market Review

Fourth Quarter 2017

Homestead Funds

Summary

- The fourth quarter saw an acceleration of stock market gains compared to the already favorable performance through the first nine months of 2017. The bulk of the broad-based quarterly advance took place in the month leading up to the passage of the tax cut bill in the House of Representatives on December 20.

- While the overall stock market trades above average valuation levels, the rally has fundamental underpinnings. Stronger than expected readings on economic data produced higher forecasts for GDP and corporate earnings growth. Unemployment remained at 4.1% throughout the quarter as monthly hiring remained well above 100,000 jobs. Consumer confidence recorded new highs, and inflation remained restrained.

- The Federal Open Market Committee (FOMC) followed through as expected in December, hiking the federal funds rate by another quarter-percentage point. Governors also forecasted higher GDP growth for 2018. Despite crude oil hitting three-year highs at $60/barrel, core inflation has been running shy of the Fed's 2% target rate, with wage growth remaining remarkably subdued.

Market Review 4th Quarter 2017

Building anticipation of sweeping cuts in corporate and individual tax rates, along with continued robust readings on economic growth and employment, helped to propel U.S. stocks higher in the fourth quarter of 2017. Bonds faced headwinds, as the Fed continued to raise short-term interest rates at a measured pace, while an uptick in global growth and more hawkish central banks, especially in Europe, pushed long-term rates higher.

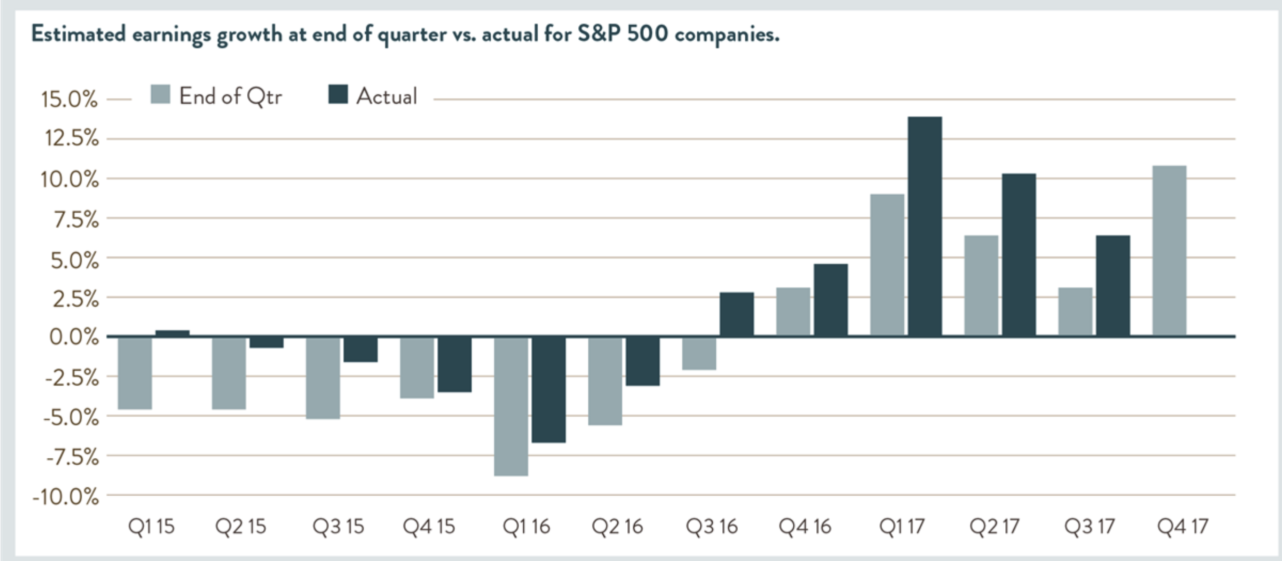
Stocks Surge Into 2018

Amid a backdrop of solid economic numbers and rising hopes for enactment of sweeping tax reform, stocks enjoyed substantial gains during the fourth quarter. Large-cap stocks outperformed small caps, and growth stocks performed slightly better than value. The S&P 500 Index returned 6.6%, as all major market averages recorded new highs. The Dow Jones Industrial Average cleared two milestones at 23,000 and 24,000 on its way to closing above 25,000 for the first time on January 4.

Although lagging slightly behind performance of Japanese and emerging markets equities, U.S. stocks widely outperformed European counterparts in the fourth quarter. Fears of an overly hawkish European Central Bank rose (ECB) after the organization suggested at its December meeting that it may take additional steps ahead of the scheduled end of asset purchases in September to scale back extraordinary monetary stimulus that had earlier helped to produce negative interest rates in Europe.

Consistently strong readings on consumer confidence, industrial production, and other measures of measures of economic health suggest accelerating growth during the fourth quarter. Corporate profit growth is also forecasted to accelerate, thanks to the overall positive economic outlook, as well as the positive impact of tax cuts on consumers, and especially on businesses, which benefit from a cut in the top corporate rate from 35% to 21%. Year-over-year fourth quarter earnings growth for companies in the S&P 500 Index is expected to climb 10.8% in the fourth quarter, up from 6.4% in the third quarter.

Earnings Tend to Surprise on the Upside



Source: Factset

Large-cap stocks outperformed small caps, and growth stocks performed slightly better than value.

Evidence of a strengthening economy pushed rates on credit securities maturing in 10 years or less toward one-year highs during the fourth quarter, but the rate rise did little to diminish a steady march higher by stocks. Rebounding interest rates provided a boost to the financial sector, as banks of all sizes — from multinationals to community banks — stand to see an increase in their lending margins, which improves profitability.

Tax Cuts And Wage Growth

Wage growth has been noticeably muted as the economy accelerated, especially given the low level of unemployment and growing number of Americans entering or returning to the labor force. Wage growth appears likely to tick higher with the labor market looking especially tight. According to the Bureau of Labor Statistics, 5.9 million jobs went unfilled in November, and the ratio of unemployed persons per job opening fell to a historic low of 1.1. By comparison, there were 1.9 unemployed persons per open job at the peak of the last economic cycle, and as many as 6.6 in the aftermath of the financial crisis in July 2009.

There is already anecdotal evidence that wage growth is picking up. While opponents of the recently-enacted Republican tax plan derided it as a boon for corporations and only modestly beneficial to middle-income workers, dozens of large companies in the wake of the bill's passage — including AT&T, Bank of America, Comcast, Fifth Third Bancorp, Southwest Airlines and Wal-Mart — announced plans to pay bonuses of $1,000 to employees. Wal-Mart, Wells Fargo and Fifth Third boosted their minimum wage.

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Tax cuts will benefit corporations across the board, and the effect can be pronounced on smaller enterprises that do most of their business within U.S. borders. Small-cap companies have high effective tax rates in general, and they stand to benefit disproportionately from lower tax rates.

Bull Market Approaches Ninth Anniversary

Stocks bottomed during the last bear market on March 9, 2009, and have rallied for nearly nine years without a 20% decline, making the current bull market the second longest on record, but memories of the steep and swift selloff in stocks during the financial crisis in 2008 are still fresh memories for many investors. According to a Gallup survey, equity ownership rates remain down sharply from 62% during the 2001 to 2008 period, to 54% from 2009 to 2017. Excessive levels of bullishness tend to coincide with market tops, but this reading of retail investors' exposure to equities indicates that substantial buying power is still on the sidelines and could flow back into the market.

One reading of sentiment does warn of possible complacency that tends to precede a selloff. The CBOE Volatility Index (VIX), a measure of investor unease, hit a series of new lows to close out the fourth quarter and remained particularly quiescent throughout the year. Bull markets are said to climb a wall of worry, so the relative absence of fear is something to be mindful of in the year ahead.

Our portfolio managers often say that they "look at value, not valuation." In other words, elevated multiples may suggest growth that's reasonably priced, if they occur alongside accelerating earnings growth.

Earnings Jump Helps Justify Valuations

Stocks overall appear to be more richly valued than they have been in recent history, based on traditional measures like the price/earnings ratio. The forward 12-month P/E of the S&P 500 is 18.4, nearly 16% above the five-year average P/E of 15.9, and almost 30% above the 10-year average of 14.2. What helps make the market's premium multiples seem less menacing are current forecasts for S&P 500 earnings growth to exceed 10%, along with additional benefits likely to accrue from a reduced tax burden.

Our portfolio managers often say that they "look at value, not valuation." In other words, elevated multiples may suggest growth that's reasonably priced, if they occur alongside accelerating earnings growth. By focusing their fundamental research on individual stocks across all sectors, they discover pockets of value that are modestly priced, relative to growth.

Bonds

Generally, bond fund indexes were lower for the quarter reflecting the upward momentum in interest rates. The yield on the 10-year U.S. Treasury note rose from 2.33% at the start of October to 2.40% at yearend. The rise in short-term interest rates was even more dramatic as the yield on the two-year Treasury note jumped from 1.47% to 1.89%.

In what markets view as the last rate hike under outgoing Fed Chair Janet Yellen, the FOMC at its December meeting boosted target rates for overnight deposits by one-quarter of a percentage point to a range between 1.25% and 1.50%. The December hike was widely anticipated, and so are at least two more in 2018. Markets viewed President Trump's pick of Jerome Powell to succeed Federal Reserve Chair Janet Yellen in February as a leadership transition that is likely to maintain the Fed's current pace of gradual tightening. Powell takes the reigns of the central bank in February, pending an expected Senate confirmation.

A decade ago, the Fed took the lead globally in implementing extraordinarily accommodative monetary policies to spur the economy in the wake of the financial crisis, including a five-fold expansion of its balance sheet to purchase securities under its quantitative easing program. The bond-buying program pushed rates near zero in the U.S., and to yields below zero when the ECB adopted similar policies in Europe. Now that central banks around the globe have begun to focus on removing accommodation, uncertainty revolves around how high, and how fast, rates will rise.

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The Homestead Short-Term Government Securities Fund (HOSGX) was down -0.29% for the quarter, slightly better than the -0.38% decline for its benchmark, the Bank of America/Merrill Lynch 1-5 Year U.S. Treasury Index. For all of 2017, HOSGX produced a total return of 0.87%, while the benchmark returned 0.65%.

The Homestead Short-Term Bond Fund (HOSBX) returned 0.05% in the fourth quarter, producing a positive return during a challenging period for fixed income. Its benchmark Bank of America/Merrill Lynch 1-5 Year Corporate/Government Index slipped -0.28% by comparison. Aided by its short duration, HOSBX also outperformed its benchmark for the full year: 1.65% vs. 1.28%.

Stocks

Major market averages in the U.S. all racked up new highs in the fourth quarter. Stocks in Japan and in emerging markets performed even better, while European equity markets underperformed the U.S. Returns from investing in growth stocks narrowly outperformed returns from value stocks.

The final quarter of 2017 was a positive period for stocks of all styles and market capitalizations. Despite a pullback in mid-November, large cap growth stocks led the way higher for the quarter. Among the sector standouts on the upside were technology, financials and energy, which benefited from oil surging back above $60/barrel. Consumer discretionary stocks from the retail and restaurant industry groups enjoyed a rebound that took hold in early November and lasted through the end of the year, accompanied by largely better-than-expected results for the holiday selling period.

The Homestead Value Fund (HOLVX) returned 8.00% in the fourth quarter, outperforming its benchmark, the S&P 500 Value Index, which produced a 6.33% return in the period. Driving the outperformance was a 22.8% weighting in the information technology sector, more than triple the 6.5% tech allocation of the benchmark, as well as very strong stock price appreciation from the fund's tech positions as a group. A decision to overweight the industrials (15.6% for the fund vs. 10.0% for the benchmark), along with superior quarterly returns from stocks in the sector — especially airlines and machinery — were big contributors to delivering outperformance relative to the benchmark. Drags on quarterly performance came from stock selection in health care and consumer discretionary sectors. Homestead Value Fund outperformed its benchmark for all of 2017, delivering a 22.17% total return for the full year, versus 15.36% for the S&P 500 Value Index.

Homestead Value's portfolio managers evaluate an organization as a whole, looking for leadership and business models they believe are well-positioned to create compounding value over long periods. These factors may include a capable new management team or a catalyst for growth in some segment. This analysis can also prompt the team to sell a stock, as they exited a long-term position in General Electric (GE) in the early spring of 2017 after assessing the likely impact on long-term cash flows and decided that value was headed in the wrong direction. Valuation looked great, but the value wasn't there. The assessment proved to be correct as shares of GE tumbled in the fourth quarter, especially after the company slashed its dividend by 50% in November.

Homestead Funds

Among the sector standouts on the upside were technology, financials and energy, which benefited from oil surging back above $60/barrel.

The Small-Company Stock Fund (HSCSX) rose 4.55% in the quarter, widely outperforming the 3.34% gain for its Russell 2000 Index benchmark. A significantly overweight (44.9% vs. 15.7%) allocation to industrials contributed to outperformance in the sector, as did superior returns form specific stock selection. Similarly, an overweight allocation and superior performance in the materials sector also drove outperformance. The fund's consumer discretionary stocks did not perform as well as the benchmark's sector positions, but there were a few performance standouts, including restaurant operators Cracker Barrel Old Country Stores (CBRL) and BJ's Restaurants (BJRI). As of December 31, 2017, 2.6% of the fund's total net assets were invested in CBRL and 1.9% in BJRI.

Total Returns as of 12/31/2017

		Average Annual				
	Q4	1-yr	3-yr	5-yr	10-yr	Since inception
Bond Funds						
> *Short-Term Government Securities Fund* (HOSGX)	-0.29%	0.87%	0.59%	0.44%	1.62%	3.13%
BofA ML 1-5 Year U.S. Treasury Index	-0.38%	0.65%	0.90%	0.75%	2.03%	3.96%
Expense ratio 0.78% (gross) 0.75% (net) (12/31/16)						
> *Short-Term Bond Fund* (HOSBX)	0.05%	1.65%	1.27%	1.40%	3.09%	4.31%
BofA ML 1-5 Year Corp./Gov. Index	-0.28%	1.28%	1.31%	1.15%	2.49%	4.53%
Expense ratio 0.76% (12/31/16)						
Equity Funds						
> *Value Fund* (HOVLX)	8.00%	22.17%	10.63%	15.87%	8.18%	10.45%
S&P 500 Value Index	6.33%	15.36%	9.47%	14.24%	6.80%	NA
Expense ratio 0.62% (12/31/16)						
> *Small-Company Stock Fund* (HSCSX)	4.55%	11.99%	8.07%	13.23%	11.07%	9.69%
Russell 2000 Index	3.34%	14.65%	9.96%	14.12%	8.71%	7.66%
Expense ratio 0.89% (12/31/16)						

The total returns shown above represent past performance which does not guarantee future results. Investment return and principal value of an investment will fluctuate. An investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be higher or lower than the performance data quoted. For performance data current to the most recent month-end, call 800.258.3030 or visit homesteadfunds.com.

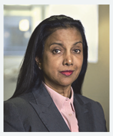
The expense ratio shows the percentage of fund assets deducted annually to cover operating expenses. Fund expense ratios shown here do not include acquired fund fees and expenses. If applicable, these additional costs are disclosed in the prospectus.

Homestead Funds

Equity Team

Mark Ashton, CFA®
Senior Equity Portfolio Manager

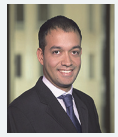
Mark co-manages RE Advisers' large- and small-cap value strategies. He is a graduate of the University of Utah, where he received a bachelor's degree in finance. He received his MBA with specialization in marketing research from the University of Southern California and also holds the Chartered Financial Analyst designation.



Prabha Carpenter, CFA®
Senior Equity Portfolio Manager

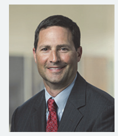
Prabha co-manages RE Advisers' large- and small-cap value strategies. She is a graduate of the University of Madras, where she received a Bachelor of Arts degree in economics. She received her Bachelor of Science degree in business economics and an MBA with distinction in finance from American University. Prabha holds the Chartered Financial Analyst designation.

Fixed-Income Team



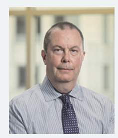
Mauricio Agudelo, CFA®
Senior Fixed-Income Portfolio Manager

Mauricio co-manages RE Advisers' fixed-income strategies. He received a Bachelor of Science degree in finance from the University of Maryland, Robert H. Smith School of Business. He minored in business culture and language, with a concentration in Spanish. He holds the Chartered Financial Analyst designation.



Marc Johnston, CFP®, ChFC®, CAIA®
Money Market Portfolio Manager and Senior Fixed-Income Analyst

Marc manages the Daily Income Fund portfolio and analyzes risk, return and volatility attributes of RE Advisers' fixed-income strategies. He is a graduate of Villanova University, where he received a bachelor's degree in general arts. He received his MBA from Northeastern University and holds the designations of Certified Financial Planner, Chartered Financial Consultant and Chartered Alternative Investment Analyst.



Douglas Kern, CFA®
Senior Fixed-Income Portfolio Manager

Doug co-manages RE Advisers' fixed-income strategies. He is a graduate of Pennsylvania State University, where he received a bachelor's degree in business administration specializing in insurance and real estate and his MBA in finance. Doug also holds the designation of Chartered Financial Analyst.

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Past performance does not guarantee future results.

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Investments in fixed-income funds are subject to interest rate, credit and inflation risk. Equity funds, in general, are subject to style risk, the chance that returns on stocks within the style category in which the fund invests will trail returns of stocks representing other styles or the market overall. 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 or financial resources, or their management teams may have less depth and expertise, compared with large-capitalization companies.

Index Definitions: The **BofA Merrill Lynch 1 – 5 Year U.S. Treasury Index** measures the performance of short-term U.S. Treasury securities. The **BofA Merrill Lynch 1 – 5 Year Corp./Gov. Index** measures the performance of U.S. government and investment-grade corporate debt. The **Dow Jones Industrial Average** measures the stock price performance of 30 actively traded, blue chip companies. The **MSCI EAFE Index** represents the performance of large and mid-cap securities across 21 developed markets, including countries in Europe, Australasia and the Far East, excluding the U.S. and Canada. The **MSCI Emerging Markets Index** represents the performance of large- and mid-cap securities in emerging market countries, including China, South Korea, Taiwan, India and Brazil. The **Russell 1000 Index** is a subset of the Russell 3000 Index and measures the performance of the 1,000 largest companies in the Russell 3000 Index. The **Russell 2000 Index** is a subset of the Russell 3000 Index and measures the performance of the 2,000 largest companies in the Russell 3000 Index. The **Russell 1000 Growth Index** measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values. The **Russell 2000 Growth Index** measures the performance of those Russell 2000 companies with higher price-to-book ratios and higher forecasted growth values. The **Russell 1000 Value Index** measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values. The **Russell 2000 Value Index** measures the performance of those Russell 2000 companies with lower price-to-book ratios and lower forecasted growth values. 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. The **Standard & Poor's 500 Value Index** is a subset of the S&P 500 Index and consists of those stocks in the S&P 500 Index exhibiting the strongest value characteristics. Indices are unmanaged and investors cannot invest directly in an index. Unless otherwise noted, index performance does not account for any fees, commissions or other expenses that would be incurred.

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