Homestead Funds

Our Perspectives: Long-Term Value Investing in a Short-Term Performance World

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

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Our equity team explains their approach to identifying opportunities and determining which have the characteristics of high-quality investment candidates.

Although the overall stock market may not appear cheap based on historical valuations, the proper amount of due diligence still reveals long-term opportunities to invest in high-quality companies that have the potential to reward shareholders.

Finding Value in Every Market

Even with the bull market in stocks well into its tenth year, it is no easier or harder to identify compelling investment opportunities. But when the market seems to know only one direction — up — it can be hard for value managers to stand out.

Value investing is not just identifying and jumping into stocks that appear to be trading below their true worth. Many companies that appear to be cheap are cheap for good reason. These reasons may include declining sales, earnings, profitability or market share. Just because a stock trades at a low price-earnings multiple, a measure of how expensive a stock is, does not mean that it's an attractive investment, especially if the fundamentals of the business are deteriorating.

We aim to achieve the best balance of generating returns and avoiding losses, which means that we focus on value instead of valuation. We look at companies as a whole, asking whether the management teams and business models position those companies to create value over long periods of time. In our opinion, the best company management teams demonstrate an ability to allocate capital in ways that benefit their stakeholders, serving as virtual compounding machines for long-term shareholders.

What's in a Name?

While industry categorizations can be useful in organizing returns for a benchmark, we often find that the mismatch between those categorizations and the actual drivers of the business fundamentals can create opportunities for those who have taken the time to do their due diligence.

As an example, **Dycom,** one of the top ten holdings as of March 31, 2018, in the Homestead Small-Company Stock Fund, is classified as an industrial, but the bulk of the company's work is focused on the expansion of broadband telecommunications. Similarly, **Visa,** one of the Homestead Value Fund's top holdings as of March 31, 2018, is classified as an information technology company, but we'd argue that it is a financial services company because it receives a fee each time a cardholder makes a purchase with a Visa card.

A foundation of our approach to stock selection has always been a willingness to seek out situations in which we can benefit from endurable long-term trends and partner with capable managers. We go where there is value, unconstrained by arbitrary sector and industry classifications which can obscure the true drivers of a business.

Disruption Across Sectors

We also seek out companies that understand how to manage disruptive innovation. It is our belief that disruption is about more than developing amazing technology. Companies must also be focused on their customers' needs, otherwise they are at as much risk of falling victim to the disruption, as they are of capitalizing on it. Anytime an established process can be replaced by another better, faster or cheaper option, there are repercussions, but improvements that deliver better value to customers have greater potential for true disruption.

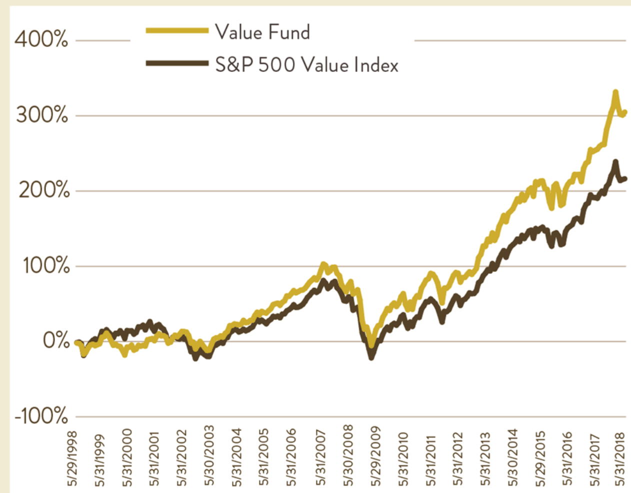
For example, online shopping continues to grow and reshape the retail landscape, but rather than buying the retailers, we're finding opportunities among trucking companies like **Werner Enterprises** that have proven themselves to be highly adaptable to the booming market for delivery logistics. They literally drive the growth of online commerce. Trucking is a large but inefficient industry where trucks are often underutilized, resulting in higher trucking costs for retailers. Werner is a leader in fleet efficiency, helping their customers take advantage of new technology that keeps supply chains in synch with customer demand.

Our management team seeks to invest in quality, sustainable businesses and to build a well-diversified portfolio that yields a competitive advantage over the long haul.

Rewarding Patient Investors

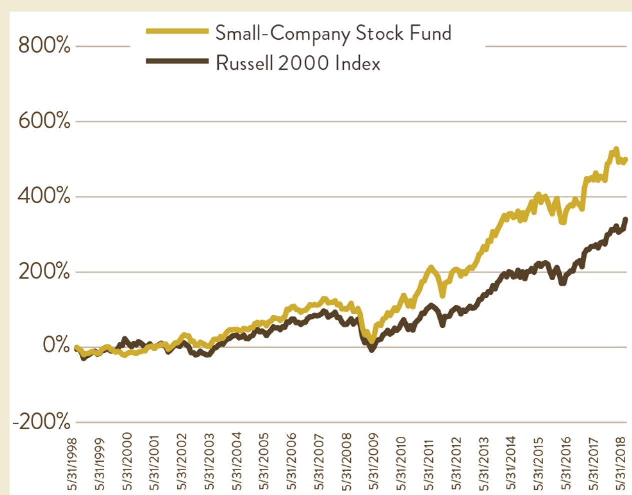
These graphs show the net cumulative returns for the Value and Small-Company Stock Fund versus their benchmarks over the past 20 years, a time frame that included different economic and market conditions. The cumulative return is the percentage increase or decrease of the fund for the indicated time frame.

Value Fund vs S&P 500 Value Index



Source: Bloomberg, net cumulative returns for the past 20 years. Fund's inception date is November 19, 1990.

Small-Company Stock Fund vs Russell 2000 Index



Source: Bloomberg, net cumulative returns for the past 20 years. Fund's inception date is March 04, 1998

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TE Connectivity also embodies our approach to finding a lower-risk way to invest in innovative technologies. The sensor maker's devices are in high demand as the Internet of Things (IoT), an enormous network of objects and machines, requires the collection of vast amounts of data via sensors. This is a case where we're investing in the typically high-growth, high-risk IT industry, but doing it with a typically lower risk manufacturing company.

Searching For Catalysts

Our process is based on fundamental research, so we consider a host of qualitative and quantitative factors. One of the most important factors is a catalyst for growth — examples include corporate events like a spinoff or merger, major legislative or regulatory policy change that affect the business or an experienced management team launching an entrepreneurial enterprise.

Leidos, an information technology outsourcing company specializing in government contracts, with an emphasis on defense and intelligence work that was spun out of SAIC. After its split, Leidos bought Lockheed Martin's IT consulting business, boosting share and efficiency in the government market.

Legislative and regulatory changes over the past year have been beneficial for the financial sector. This is especially true for smaller banks, which have had a comparatively more difficult time than big banks in keeping up with requirements of the Dodd Frank Wall Street Reform and Consumer Protection Act, the Consumer Financial Protection Bureau and other stringent government oversight coming out of the financial crisis. **Texas Capital Bancshares** is a beneficiary of the trend toward less regulation, not only in banking, but for small business in general, stimulating loan demand from customers. **Encore Capital Group,** by contrast, benefits from tighter regulation. The company buys charged off debt, and attempts to collect those debts. When new rules restricted their ability to contact debtors, and imposed heavy fines for violations, Encore established a first-rate compliance process and used that as a competitive advantage to gain market share.

We look at companies as a whole, asking whether the management teams and business models position those companies to create value over long periods of time.

Staying On Top Of Our Stocks

Deciding if and when to sell is just as important as making the decision to buy a stock. We are patient, long-term investors, and while we try to minimize turnover in the funds (because taxes and transaction costs diminish returns over time); we constantly evaluate the stocks we own, and compare them to other opportunities in the market. As long as valuation remains reasonable, fundamentals show improvement and we still have faith in management, we are likely to continue holding the stock to take part in the long-term value creation process.

Total Returns as of 3/31/2018

		Average Annual				
	Aggregate YTD	1-yr	3-yr	5-yr	10-yr	Since inception
Equity Funds						
> *Value Fund* (HOVLX)	-2.33%	14.10%	9.23%	12.12%	9.24%	10.25%
S&P 500 Value Index	-3.57%	7.69%	8.40%	10.87%	7.42%	NA
Expense ratio 0.60% (12/31/17)						
> *Small-Company Stock Fund* (HSCSX)	-2.34%	9.89%	5.74%	10.27%	11.53%	9.43%
Russell 2000 Index	-0.08%	11.79%	8.39%	11.47%	9.84%	7.56%
Expense ratio 0.88% (12/31/17)						

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.

Percentage of Total Investment for Stocks Mentioned as of 3/31/18

Value Fund		**Small Company Stock Fund**	
Leidos	1.5%	Dycom	9.1%
TE Connectivity	2.4%	Encore Capital Group	4.8%
Visa	3.9%	Texas Capital Bancshares	4.1%
		Werner Enterprises	4.1%

Past performance does not guarantee future results.

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 **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 **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.

The views expressed are those of the individuals as of May 24, 2018, 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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