Homestead Funds
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Q1 2021: Rebound Continues as Vaccinations Climb

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Mark Santero: Hi, this is Mark Santero, and I want to welcome everybody to the first quarter of 2021 Homestead Funds Market Review. Our caption for this first quarter is "Rebound Continues as Vaccinations Climb."

I'm your moderator for today and appreciate everybody jumping on. With me, our two senior portfolio managers, Mauricio from the fixed-income team and Prabha from our equity team. Thank you, Mauricio and Prabha.

So, what's our agenda today? Like past quarterly updates, we're going to discuss first the macro-economic conditions and factors that we faced. Then we're going to go over briefly the fund absolute and relative performance, what the drivers of return were for the funds, and last, but most importantly, outlook and fund positioning going forward.

So, without further ado, let's get to the content. Prabha, why don't you take it away?

Prabha Carpenter: Thank you, Mark. It's been over a year post the declaration of the pandemic and working from home. We've in recent weeks seen the Dow Jones and the S&P 500 reach new highs, and earnings for the first quarter of 2021 have started coming in. We're in the third week of earnings releases. The aggregate earnings for the S&P 500 for the first quarter are expected to end up at about 190 — a 38% increase year over year. And the S&P has typically peaked when earnings have peaked, and strategists and pundits say this peak may be many quarters away. So, we're optimistic on that basis.

As Mark mentioned, vaccines, fiscal stimulus and accommodative monetary policy are propelling nominal GDP growth rates in the high single digits,

Now I'll turn it over to my colleague, Mauricio, to start the discussion on the fixed-income markets.

Mauricio Agudelo: Thank you, Prabha. On the fixed-income side, expectations for a faster reopening of the economy amid the increasing vaccination rates in the U.S., additional fiscal stimulus, prompted interest rates five years and out in the first quarter and the yield curve to steepen. For instance, the 10-year yield rose from 0.92% at the end of the year to a post-pandemic high of 1.74% at the end of the quarter. The rising yields certainly pressure bond prices generating negative returns during the quarter across the fixed-income funds complex. The absolute negative returns were somewhat offset by investment-grade corporates; this issuers is performing quite well during the quarter.

One particular measure that we look at, the option-adjusted spread of the Bloomberg Barclays U.S. Credit, tightened from 92 basis points to 86 basis points during the quarter — another bullish sign on the ongoing recovery.

Let me pass it along to you, Mark.

Mark Santero: Thank you, Mauricio. It's a quick pass because I'd love for you to now comment on the fixed-income funds' performance and drivers of return for the first quarter. Let's talk about the Short-Term Bond Fund first.

Mauricio Agudelo: For the Short-Term Bond Fund, as previously mentioned, we experienced negative returns during the quarter. The Short-Term Bond Fund posted a -0.63% return while the benchmark, the Bank of America 1-5 Year Corp./Gov. Index, returned -0.52%. We trailed the benchmark by 11 basis points during the quarter.

What didn't work during this quarter: The yield curve steepening with bonds in the five-year maturity bucket underperforming the two-year and the three-year due to rising rates, where the five-year Treasury yield rose from 0.36% at the end of the year to 0.94% at the end of the quarter, certainly hurt absolute and relative performance during the quarter.

Now on the flip side, what worked during the quarter? The fund's underweight to Treasuries and overweight to corporates and asset-backed securities. The extra yield offered by these two sectors provided a cushion to the negative impact to returns from pricing yields. There are two components to fixed-income returns: price appreciation or depreciation, and the other component being the coupon, the yield. But it takes time to accrue and earn that yield. And we are in the process of doing that.

Next in the portfolio snapshot, I would like to highlight that we still have high conviction in corporates, ABS [asset-backed securities] and taxable munis as the economy continues to recover. Additionally, throughout the quarter, we shortened the duration of the portfolio to mitigate somewhat the rising yields versus the benchmark. That being said, we still favor the five-year part of the curve, as we feel there is adequate compensation in terms of extra yield.

Next, let me go to the Intermediate Bond Fund. During the quarter, the Intermediate Bond Fund returned -2.99%, while the benchmark, the Bloomberg Barclays U.S. Agg Bond Index, returned -3.37%. Now what didn't work during the quarter? From an absolute return perspective, the rising yields generated negative returns during the quarter for the fund. It was a difficult quarter for the benchmark, the U.S. Agg Index, which posted the worst quarterly return when looking at the last 20 years of data.

What worked? Relative to its benchmark, the fund outperformed by 38 basis points during the quarter, the main contributors being underweight Treasuries and mortgage-backed securities versus our overweight position in industrials and asset-backed securities.

Next for the portfolio snapshot, we are overweight corporates, asset-backed securities and munis versus underweight Treasuries and mortgage-backed securities versus the benchmark. We perceive the risk/reward of this positioning to be attractive under the current environment. Lastly, we have shortened the portfolio's duration somewhat as part of a more defensive strategy versus the prospect of higher rates.

Mark Santero: Thank you, Mauricio. It certainly was an interesting first quarter for fixed income. Everybody expected bond prices to be flat or positive, but certainly with interest rates, a concern for inflation, it had a negative effect.

Let's talk now, Prabha, about the portfolios on the equity side. So, if you can, we can talk about the Value Fund first.

Prabha Carpenter: Thank you, Mark. As Mark mentioned, Homestead Value is our flagship fund, and we're proud of our double-digit returns for the quarter, up over 10%, although we're slightly behind the Russell 1000 Value, which is our benchmark, by about 119 bps [basis points]. We're roughly flat for the year and ahead on the three-, five- and 10-year periods versus the benchmark.

What helped in the quarter? First not having consumer staples and utilities helped. On an exposure basis, our communication sector contributed to overall results. We're slightly underweight the sector but outperformed the benchmark with our holdings. Alphabet was the stellar performer here. The materials sector also contributed with the gradual return to normalcy. We're overweight the sector and we also outperformed. Avery was a key contributor here.

What detracted? The benchmark energy sector was up over 30% in the quarter, and we have no exposure here, and thus the detraction. And the consumer discretionary sector detracted; it's a broad category, and we're slightly underweight the sector and underperformed. But the auto-related segments did particularly well in this quarter, and we had limited exposure there.

I point out the valuation metrics on the portfolio snapshot slide [slide 14]: At the bottom, you see the price/earnings ratio of the Value Fund versus the Russell 1000 Benchmark Value Index. We're at 17.4 times versus 18.3 times for the benchmark. And the other metric I'd also point out is the return on equity at 15.7% versus 10.6% for the benchmark illustrates and emphasizes our lower P/E [price to earnings] higher return, our quality-value approach.

I could continue with the Homestead Small-Cap Fund. Again, we're pleased with our double-digit returns for the quarter. We were up 12.94%, and we were ahead of the benchmark by 24 basis points.

What worked in the quarter? Health care — we're overweight and outperformed. In the health care sector, the contributors were Inovalon, STAAR Surgical and Medpace. They were key contributors and they appear in our top 10 holdings. The materials sector with talk of infrastructure spend also did well. And here Summit Materials was up 39% for the quarter.

What detracted? Consumer discretionary — we were underweight and we underperformed. And in the financials, two subsectors were weaker in the quarter — insurance and consumer finance.

Again, in terms of valuation our P/E is slightly higher than the benchmark, but our ROE [return on equity], this is a striking metric, for the Small Company Fund is 5.8% versus a negative figure for the benchmark. Again, we're quality-focused.

I'll turn it back to Mark.

Mark Santero: Thank you, Prabha, thank you, Mauricio, for a review of not only the portfolios for the past quarter but also what transpired in the market. So that was in the rearview mirror. Obviously, our investors care about what's ahead, and especially with a lot of the news going on with inflationary pressures on interest rates, which we did see as Mauricio pointed out in the first quarter, and the wild ride we've seen in stocks with records in the

S&P and the Dow. So, what's ahead? Mauricio, why don't you give us your thoughts on interest rates and inflation going forward?

Mauricio Agudelo: Yes, Mark. It's certainly top of mind for all investors in fixed income and in general what's going on with inflation and inflation expectations. Certainly fears of runaway inflation caused Treasury yields to rise, and these put downward pressure on prices for those negative returns during the quarter. Here, I would like to highlight for our audience today that this was the worst quarterly return for the Aggregate Bond Index in the last 20 years. However, that being said, we have experienced similar situations in the past. When I look back at 2016, when the Fed signaled that rates would start rising, we experienced a negative quarter for the Ag [Aggregate Bond Index] as well, and then back in 2013 during the taper tantrum.

Now the gray line in the chart [slide 19] displays the break-even rates, which are basically the difference between inflation-protected and nominal bonds of, in this case, five-year maturities, which implies that investors are expecting the economy to experience inflation in the near future.

The yellow line in the chart shows us the actual level of CPI [consumer price index], which has continued to rise due to one, base effects — basically we have a lower base from a year ago — and the reopening of the economy. That being said, the Fed is committed to supporting the ongoing economic recovery by keeping the fed funds rate at or near zero, and the majority of the FOMC [Federal Open Market Committee] members don't expect to raise rates until 2023. The Fed is willing to let inflation run above the 2% mark in order to achieve full employment and support the economy.

Let's recall that prior to the pandemic, the Fed actually had to cut rates in 2019 because the economy was stalling at the time. They considered that they had gone a little bit too far raising rates in 2018. We have shortened the portfolio's duration relative to the benchmark as part of a defensive strategy versus the possibility of higher rates. We also believe that as long as the moving yields is orderly, the fixed-income market is in good health and bonds will continue to serve the purpose of diversifying wealth and investments for individuals and institutions.

And let me hand it over to Prabha now.

Prabha Carpenter: Thank you, Mauricio. We would like to highlight this Value Rebounds chart [slide 20], and it's been a long time coming. After lagging in the first quarter of 2020, Value has rebounded significantly — the widest margins in 20 years — and we're pleased. Our flagship fund, as I said, is Homestead Value.

And this goes back to some comments that Mauricio made regarding interest rates and the Fed's focus, and the Fed's focus is on employment. We need to gain back those 8 million-odd jobs. The focus is on jobs rather than inflation. One of our sectors that performed particularly well in the first quarter is the financial sector. And it's a big component of Value strategies. Our financial sector performance in the first quarter was about 18%, and it's one of our larger overall weights at approximately 20%. So financials helped in the quarter, and banks, which received a less-than-favorable name in the last crisis, are part of the solution. There were no excesses. So we're looking forward to seeing continued outperformance in the financials, in quality value, our high-conviction names, across both large-cap and small-cap strategies. We're optimistic that this favorable return will continue, although there may be slight pullbacks. We're optimistic from what we're hearing from companies and managements from these earnings calls.

Now, I'll turn it back over to Mark.

Mark Santero: That concludes our first-quarter market outlook and update. I want to thank Mauricio and Prabha for their thoughts and sharing their views on not only how the portfolios performed in the first quarter but the market outlook and views going forward.

Everybody on the phone or on the webinar here, if you'd like more information, please send me an email or give me a call. That's my number. That's my email. We always look forward to hearing from our shareholders. I hope everybody's safe and well, and we look forward to our next update in the second quarter. Thank you very much.

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

Basis points (bps) refers to a common unit of measure for interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01%, or 0.0001, and is used to denote the percentage change in a financial instrument

Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market

Commercial mortgage-backed securities (CMBS) are fixed-income investment products that are backed by mortgages on commercial properties rather than residential real estate.

Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

The Dow Jones Industrial Average (DJIA) is a widely-watched benchmark index in the U.S. for blue-chip stocks.

ICE BofA Merrill Lynch 1–5 Year Corp./Gov. Index measures the performance of U.S. government and investment-grade corporate debt.

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.

Option-adjusted spread (OAS) is the yield spread that has to be added to a benchmark yield curve to discount a security's payments to match its market price, using a dynamic pricing model that accounts for embedded options.

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.

Standard & Poors (S&P) 500 is a market-capitalization-weighted index of the 500 largest U.S. publicly traded companies.

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