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Homestead Funds

Equity Update: Q4 Update and 2019 Outlook

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SUMMARY

- **U.S. stocks tumbled during the quarter despite continued strength in company earnings.**
- **Labor market data was a bright spot, showing better-than-expected hiring.**
- **The Federal Reserve hiked its interest rate target a fourth time for the year. Interest rates fell and the yield curve flattened further, coming closer to an inverted position.**

Darryl Keeton: Thank you very much. Good afternoon everyone, and welcome from sunny Arlington, Virginia. My name is Darryl Keeton, head of distribution for Homestead Funds, and I want to welcome you to today's year-end update and 2019 outlook call from Homestead's full investment management team.

Joining me today on the call are members of our equity team: Prabha Carpenter, senior equity portfolio manager; Jim Polk, senior equity portfolio manager; and Peter Blackstone, senior equity analyst. Also joining are members of our fixed income team: Mauricio Agudelo, senior fixed-income portfolio manager, and Ivan Naranjo, fixed-income portfolio manager.

We've modified our call format based on feedback we received from you, that you want to hear more from the fixed-income team. So we're happy to have them join us today. Our agenda will be a 30-minute session comprised of a moderated discussion focused on today's economic backdrop, a performance update on our fixed-income and equity offerings, the investment teams' current thoughts on fund positioning, and finally our views on any existing trends or ideas they're following.

After the commentary, we've reserved a bit of time for Q&A, and we ask that you submit your questions using the chat feature on the WebEx platform. We'll try to tackle as many of those questions as we can during the allotted time.

I'll now turn the call over Prabha Carpenter, who will get us started on the current macro-economic picture.

Prabha Carpenter Thank you, Darryl. We're pleased you've joined us for this webcast this afternoon. We want to take this opportunity to highlight the macro backdrop and events in the fourth quarter that generated considerable volatility in the capital markets. I will address a few of the headwinds the markets faced, and then my colleague, the senior fixed-income portfolio manager, will focus on the fixed-income markets. We will discuss the Homestead Funds' performance and prospects.

Our goal over the next few minutes is to share with you why we as long-term investors are excited about prospects for our portfolios, recent fluctuations notwithstanding.

We'll start on slide six. As 2018 began, there was optimism regarding synchronized global growth, thoughtful central banks, more favorable tax legislation, and reasonable trade dialogue with China and other trading partners. As the year progressed this optimism was replaced with indications of a synchronized global slowdown: government dysfunction, here and abroad; the Federal Reserve on autopilot to raise rates and not being data dependent; and fears of a full-blown trade conflict.

Although a March deadline is approaching and trade dialogue is ongoing, a straightforward resolution does not appear imminent. Some of our portfolio companies have been coping with trade issues in a number of ways. Higher costs for some companies are being passed on to customers. Others have altered supply chains to minimize the tariff impact. Others have differed investment, waiting for clarity. Slower growth, higher costs, diminished efficiency and more negative sentiment are some of the results.

In addition to slower growth in China, Europe and the emerging markets, and increased trade tensions, we also witnessed a drop in oil prices in the fourth quarter from over $70 a barrel to under $45. **Though this may be perceived as a long-term benefit as far as the consumer is concerned, the immediate impact was seen as a confirmation of the global slowdown.**

In the fourth quarter, the Federal Reserve announced plans for additional interest rate hikes in 2019 after hiking rates in December for the fourth time that year, ignoring data that showed a global economic slowdown, the benign nature of inflation, and weakness in sectors like housing and autos. Many sectors experienced double-digit declines. Banks sold off as recessionary concerns became elevated.

The yield curve flattened, which was viewed as confirming a slowdown in global and domestic growth. A flat yield curve precedes an inverted yield curve, which in most cases precedes a recession.

And now, with that logic, I turn it over to my colleague Mauricio, our senior fixed-income portfolio manager.

Mauricio Agudelo Thank you, Prabha.

The labor market continued to be very strong and certainly the bright spot for the economy. Non-farm private payrolls above 200,000 on average for the fourth quarter and for all of 2018 show better-than-expected hiring. Other labor market indicators show strength during the period, with initial jobless claims in the low 200,000s and the unemployment rate slightly below 4 percent — still near multi-decade lows.

Average hourly earnings year over year were slightly above 3 percent, near the peak for this economic expansion — certainly inching up as employers need to attract and retain skillful workers.

All the above economic indicators combined with solid GDP growth gave the green light for the Fed to increase the fed funds rate by 25 basis points, marking the fourth increase of 2018, and the ninth increase of the cycle. However, projections for the path of monetary policy for 2019 were seen as too optimistic by market participants, with the Fed projecting two rate increases and the run of its balance sheet to remain on autopilot. The market was cautiously watching oil prices, equities, inflation, trade discussions with China and more importantly the shape of the yield curve — which flattened even further, as Prabha just mentioned, during the quarter, with the spread between the two-year and the 10-year U.S. Treasurys reaching 10 basis points.

All the above warning signs drove risk assets to sell off and safe havens like U.S. Treasurys to rally as investors sought shelter during a period of increased volatility. **Since the December meeting, the Fed has made it clear to investors and market participants that monetary policy will be flexible and data dependent going forward, therefore alleviating some of these concerns.**

Now, to go over the fund performance on the fixed-income side, Ivan Naranjo.

Ivan Naranjo Thank you, Mauricio. If you want to switch to slide eight?

I'll be discussing the performance update and sector diversification. The Short-Term Bond Fund for the fourth quarter of 2018 trailed 88 basis points the benchmark, which is the Bank of America 1-5 Year Corporate/Government Index. On a year-to-date basis for 2018, it outperformed its benchmark by 29 basis points.

The main drivers of performance throughout the year were a shorter duration relative to benchmark, the strong conviction on U.S. consumer, an allocation to sectors and/or securities that would benefit given our view. The last quarter of 2018 was particularly challenging for risk assets, which drove a flight to quality to Treasurys and risk-free securities. This caused our duration and yield curve positioning to detract from overall returns in the tail end of 2018.

For instance, the United States two-year Treasury rallied 33 basis points. The five year rallied 44 basis points, and credits spreads, as measured by the Bloomberg Barclays Credit OAS, were 43 basis points wider. The majority of this move took place in the last half of December, and it was very aggressive.

So we switch to slide nine, the portfolio snapshot. As you can see, the majority of the Index is based in U.S. government obligations. We find better value away from these through corporate, asset-backed and municipal bonds, as you can observe in the chart. Within these sectors we have identified certain pockets where we see better risk-adjusted returns, for instance, financials in the corporate sector, consumer asset-backed securities in the form of auto and consumer loans — all of the former within the high-quality universe. **A good example of these is the asset backs we invest in, which are the most senior trenched with high credit ratings and high credit enhancements with short average life but great compelling yields or spreads over Treasurys of the same maturity. Additionally, we always look for securities rated no lower than single A.**

I will pass it along to Prabha, our senior equity portfolio manager, so she can discuss in detail the equity portfolios.

Prabha Carpenter: Thank you, Ivan. Before I turn to the slides on the Homestead Value Fund and the Homestead Small-Company Fund, I'd like to introduce the newest member of the equity team: Jim Polk, senior equity portfolio manager. He has an impeccable investment background, and he's a thoughtful team player. We're very excited to have Jim join our team.

Jim, if you'd like to chat...

Jim Polk: Thanks, Prabha, thank you. So I just joined two weeks ago. It's absolutely a great team. Prabha, Peter and the rest of the team have really been making me feel very welcome here, and I'm excited to be a part of it, and obviously looking forward to adding value to the team.

Just as a quick background, I spent most of my career at Putnam Investments, a Boston-based mutual fund where I started as a generalist analyst but really had a lot of sector focus on health care and consumer. Most of my time was as a portfolio manager, where I ran small-, mid- and large-cap value products, all with kind of a — like here — bottom-up, fundamentally driven process. But there we also wore the analyst hat, so we had portfolio management responsibilities and analyst responsibilities.

So again, I'm really looking forward to being a part of this team, and for everybody welcoming me to the team. With that, Prabha, I'll turn it back to you.

Prabha Carpenter Thank you, Jim. We could turn to slide 11, which has the Homestead Value Fund performance.

We were behind for the quarter, but we were ahead for the year, the three-year, five-year, 10-year periods. **And we basically try to find superior stocks that outperform over the long haul, looking for uncrowded, overlooked, out-of-favor, under-followed diamonds in the rough.**

Slide 12 gives you greater portfolio detail: the top 10 holdings and the sector positioning versus the benchmark. You can see our top holdings: Visa, Pfizer, Microsoft, Southwest, Cisco, DowDuPont, Bristol Myers, Parker Hannifin, Avery and Alphabet.

One area we look at in both large- and small-caps are spin-offs, cast-offs and amalgamations. This area receives a considerable amount of our attention. We read the filings. We can't wait for the filings to appear. We assess the possibilities of new structures.

We mentioned DowDuPont during our last call. We think the valuation of the three spun entities — an ag company, a materials company and the specialty products company — will be greater than the value of the current stock price, and DowDuPont underperformed last year. It is a return-on-invested-capital-focused entity being captained by Ed Breen, a master capital allocator.

We could go on to the small-cap fund. We focus on fundamentals, and in periods of narrow benchmark performance, we tend to lag. We've mentioned this before in past webcasts. In periods of low to zero interest rates, there's no discernment of the difference between the financial performers and the non-performers. The freeloaders get a pass; fundamentals are overlooked.

And just in terms of some stats last year with the Russell 2000 — this is from

Furey Research — the Russell 2000 sold 27 percent from its August 31st peek. The fourth quarter last year was one of the worst in history for the small-cap asset class: 86 percent of stocks were in bear market territory, and again there was a narrow leadership in the Russell 2000.

Health care equipment and services, software and household personal products led the charge. And again there was a two-part result. There were the first nine months, and then the fourth quarter in terms of performance for the Russell 2000.

Slide 14 has Small-Company performance results. And it's painful to see the more recent results, and last year was painful. But we're ahead on a long-term basis. Slide 15 is a further descriptive of the portfolio. You can see the top 10 holdings, the sector weightings versus the benchmark and evaluation metrics. Our return on equity stands out: It is superior than the Russell 2000 Index.

In the industrial segment, which hurt us last year and which had helped our performance over the last 10 years, we owned the truckers. Industrials is a broad segment, but we own the truckers. It's a fragmented industry that is being consolidated. The top five logistics firms account for 20 percent of domestic industry revenues. In airlines, this measure is close to 90 percent. Growth is being augmented by e-commerce. Our holdings in the trucking space are run by owner-managers who are laser-focused on financials and return on investment metrics.

Barriers to entry have been raised with technology and regulations. Only the financially strong survive. Electronic logs, driver monitoring and sensors play roles to monitor rigs, engines, tires, speed; it's almost like NASCAR racing. Big data is used by management to increase operational efficiencies. It is a high-tech business. Werner and the truckers will be compounding machines over the long haul, no pun intended — this is from our newest addition, Jim. **But we think the fundamentals will be realized with a longer term outlook.**

To sum up, we're value managers. We underperform when growth and momentum dominate. But we stick to our discipline and the process that has generated superior long-term results while limiting risk with our focus on fundamentals. We think balance sheets matter, cash flow matters, capital allocation matters. We feel there will be a reversion to fundamentals, and our high-quality companies will receive favorable market attention over the long term. We believe thoughtful active management will return to prominence as rates and markets normalize.

Next, my colleague Peter Blackstone will discuss opportunities.

Peter Blackstone

Thank you, Prabha. Looking forward, we expect earnings in 2019 will grow at a significantly slower pace than they did in 2018. But as we're thinking of that we have to remember that in 2018, growth rates were artificially boosted by changes in the tax code.

In fact, in 2018 S&P 500 earnings grew double digits, but nearly 8 percent of that was due to the tax code changes alone. We do not foresee an additional 8 percent change to give the S&P another leg up in 2019, but we're optimistic as low tax rates mean higher cash generation are available for investment and growth going forward.

We're starting to see that play out in most industries already. What this should mean is that earnings revisions will start to be dictated by strong fundamentals rather than just a rising tide. This is a condition we have not seen in some time. With that said, Q4 was ugly for markets. Investors pulled an awful lot of money off the table in anticipation of slower growth rates and rising interest rates.

This resulted in the first meaningful improvement in valuations we've seen in some time. During the last webinar, we mentioned there was a material correction already in energy and technology. We've been taking advantage of these new discounted valuations during Q4, and in the meanwhile the correction broadened significantly to include financials and health care, and we've been shopping in both sectors.

While we never root for big corrections like we had in Q4, we do appreciate the opportunities that these corrections can afford. These corrections often lead to fantastic prices for even the highest quality companies, as they too are sold indiscriminately by ETFs and index funds. We've been hard at work looking for new investment opportunities and will be ready anytime the valuations correct.

And with that, I'll pass it back to Darryl.

Q&A

Darryl Keeton

Thank you, Peter. At this time we'll move to the Q&A portion of the call, and remember, please submit your questions using the chat feature of the WebEx platform. While we wait for questions to come in, I'll get us started with a question for the fixed-income group.

If you think about the outlook right now, some of the things that've taken place in the marketplace, Mauricio and Ivan, what do you think the outlook is for Fed action on the yield curve right now?

Mauricio Agudelo During the December meeting the Fed projected two rate increases and the run of the balance sheet to remain on autopilot, which certainly was not welcome by the market. Our expectation is, at this point, for the Fed to deliver one more increase in the second half of 2019. However, this is dependent on any resolution to the China trade dispute.

And in terms of the yield curve, as Ivan mentioned earlier during the performance presentation, we tend to favor the front-end part of the curve. We think the curve is too flat at this point, and we find it to be quite attractive in two years.

Darryl Keeton Okay. It looks like we have a question in. This seems to mirror the question that we had on the fixed-income side but it's directed toward the equity team. **Jim, Prabha, Peter, what is the outlook for the equity environment in the coming year?**

Prabha Carpenter I could take a stab at that. It's a very good question. As Peter said, earnings growth, so far, continues for our companies. We always listen to calls, read transcripts and talk to management. And earnings growth continues in the fourth quarter that's being reported presently. And prospects: The guidance is still for earnings growth, though not at the blistering pace of the first three quarters of 2018.

And the Fed's more recent statements have been more accommodative. The sentiment has changed. Instead of four increases it's less. And the recovery: Though chronologically long, we still see growth and we don't see a recession. And so we continue to be optimistic for the equity outlook in the coming year.

Darryl Keeton Another question has come in with more of a focus on small-caps. **Small-caps have historically been a volatile asset class. What have you all done to limit some of the volatility with the small company portfolio in the last year?**

Prabha Carpenter We've always been cognizant of risk, and we wanted to see fundamentals. You wanted to see strong balance sheets, you wanted to see strong business models. And I think at the end of the day, the strength on the balance sheet and business model strength will rule the day. Although it doesn't seem like we received the attention in the last year, I think at some point the fundamentals will truly matter, and we're entering a period where interest rates are more normalized, where the forty-odd percent of the Russell 2000 are non-earners.

For us, earnings and balance sheets always were at the core, and I think we minimize risk over the long term by focusing on our core strength.

Darryl Keeton

Our next question is about China. **How could a future deal struck with China impact the way you are managing the portfolio right now?**

This could be for anyone to answer.

Prabha Carpenter

I think the trade situation adds uncertainty, higher costs, and globalization's hallmark is lower costs across the spectrum, and the ability to source anywhere. And with that model back, it would impact the financials of all entities, and we think trade war is bad for whatever country. It's bad for the capital markets — and capitalism in particular.

Jim, if you'd like to add...

Jim Polk

I would just add — I think it's putting a fear of a recession out there and holding multiples down. And so all the things Prabha said are absolutely correct, but I also think there's a sentiment aspect that goes with that, that kind of keeps multiples in the market down. Trying to call the next recession and you're pointing to the U.S. China relations as one element of that. I think if that were to go away, that would be viewed really positively in the market.

Darryl Keeton

Great — thanks, Jim. Looks like this has come in for the fixed-income team. **Where do you all believe we are in the credit cycle? And how are you thinking about that in current positioning for the portfolios?**

Mauricio Agudelo

I think we are certainly in the late to later stages of the credit cycle. We've seen some of the warning signs. This could get extended by a resolution to trade with China, for sure. And in terms of positioning, we tend to favor higher quality. I think the up in quality trade is the way to go right now.

Darryl Keeton

Ivan, anything to add?

Ivan Naranjo

I think I'll add a little bit about China and the positioning. If things were to come to a resolution, you have to keep in mind that it may put the Fed back in play, and that kind of jives along with the fact that we're looking at a zero-to-one hike in the upcoming years. So I think it's definitely one thing to keep an eye on. And with that in mind we're managing duration, being cognizant of that possibility.

Darryl Keeton

Okay. Thanks everyone, but looks like we're up against the time we've committed for today's call. For those of you who are online and who called in, if we didn't get a chance to get to your question, please feel free to follow up with me directly at **703.907.6087**.

Today's call, slide deck and the related materials will be posted on our website at **www.homesteadfunds.com** in the coming days. I want to thank you for joining us today, and have a good afternoon.

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