INVESTMENT
UPDATE

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A TALE OF TWO MARKETS

A NOTE FROM JOE ROMANO

It's hard to believe that 2017 is already coming to a close, and like many of you, I am amazed at how each year seems to go by quicker than the last. As I think of the year gone by relative to stock market events, one theme immediately emerges: the difference between the "market" that people follow in TV headlines and cocktail party chatter and the disconnect with the broader stock market underneath. This update goes hand in hand with the enclosed explanation that Doug Geisser writes as he delves into the composition of various market indices and the distortion that can result and impact today's market.

To begin, today's main headline continues to be the defiant, if not still surprising, continuation of the Trump rally 13 months after his election victory. The stock market seems to make routine record highs as the Dow sits at 23,600, and the S&P and NASDAQ close at historic levels.

Romano clients have also participated in the rally and drank from the punchbowl. By and large, most clients had a banner year in 2016, handily outperforming their target benchmark. This was due to a combination of smart stock picking and fortuitous timing, allowing us to buy stocks on sale with two short lived pullbacks in the market of 10 to 12 percent. The January 2016 retreat lasted only a few months, while the June 2016 Brexit selloff lasted a mere three weeks before the market gained everything back.

But perhaps the biggest reason for outperformance was that value investors, who tend to focus on beaten up, discounted companies based on market fundamentals and dividend yield, were heartily rewarded in 2016. In 2016 the Russell 1000 Value index was up 17.34% while its growth counterpart was up only 7.08% for the same period. In stark contrast and as is often the case, this trend has had a sharp reversal in 2017, with the Russell 1000 Growth Index trumping value 20.40% vs. 7.62% through the first three quarters.

So what's really going on? Should we be concerned? Is there something the numbers and the headlines don't tell us?

Here are a few other observations, which offer some explanation. Many investors are aware that the VIX, the most popular market volatility indicator is near record lows. But if you look beyond the headlines, you see a vastly different picture. Individual stocks and sectors have been extremely volatile in 2017, and have been separated into a group of "haves" and "have nots" especially during the latest earnings season.

The first group is the group of large technology companies like Amazon, for example. This company has been a major market participant because if there is one theme for 2017 it is what I call "the Amazon is taking over the world" effect. Amazon has made its presence known in every retail sector, and this year made a foray into groceries with its takeover of Whole Foods. Meanwhile, it threatens to move into other areas like pharmaceuticals and healthcare.

The battle lines have been drawn and this has created the latter category of "have nots," which is not surprisingly, comprised of many retail names like department stores and even stalwarts like CVS and Walgreens which trade near 52 week lows.

A deeper dive into the numbers shows that over the 30 day period ending November 7, the NASDAQ 100 was up over 4%, but the average stock as measured by the S&P Equal Weighted index was up only 0.66%. The SDOG ETF, an equal weighted index of the 5 highest yielding stocks in the S&P 500's 10 sectors was actually down 0.65% in that period. This is a trudging for the types of stocks that we favor long term.

The more this type of market dynamic occurs with a glass ceiling separating the winners and the losers, the more I believe we are not so much in a market bubble as much as we are in a Mega Cap bubble (see Doug's article). This could set the stage for a sizeable, emotional decline that could erase many gains.

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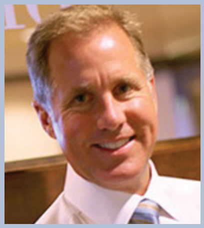
HAS PASSIVE INVESTING SKEWED THE PERFORMANCE OF STOCK INDICES?



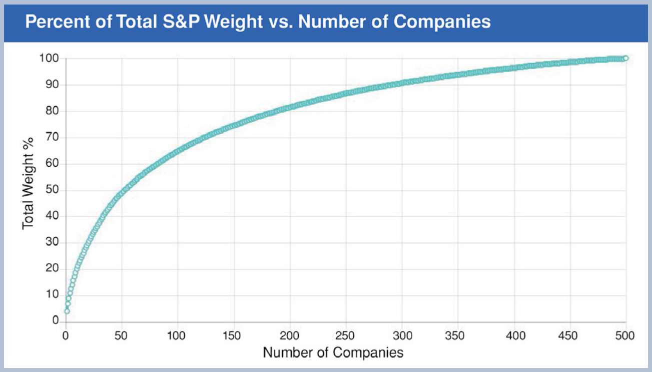
The ascent in passive investing (purchasing a fund that mirrors the performance of a certain stock index) over the past 8 years has created investment challenges and may have skewed the prices of the underlying stock components. To examine this we need to look first at how various stock indices are comprised.

We are all likely familiar with the Dow Jones, S&P 500 or NASDAQ indices. But what do each of these indices track and what are they comprised of? Many are likely not aware that the Dow Jones index tracks only 30 Industrial based companies. When newscasters talk about the market, they typically refer to the Dow Jones index. However, is measuring the performance of only 30 companies representative when there are nearly 4000 listed companies that are actively traded on US exchanges? The S&P 500 index is a little more diversified and encompasses the performance of 500 large cap US companies. The NASDAQ 100 index is made up of the largest 107 non-financial companies listed on the NASDAQ stock exchange. In addition to the different number of companies within each index, the weighting that company has on the index will depend on if it's a market cap or price weighted index (a company's market cap is the total number of shares outstanding multiplied by the share price).

Even though the S&P 500 and NASDAQ have a greater number of participants, they are not as diversified as they seem because they are market cap weighted indexes. That means the larger a company's market capitalization, the greater percentage it will comprise of an index. As an example, the NASDAQ 100 index has an approximate market cap of 7.3 trillion dollars. The largest component, Apple has a market cap of 888 million or 12.1% of the index. The top five companies (Apple, Microsoft, Amazon, Facebook and Google) within the NASDAQ 100 index comprise a whopping 43% of it. So, when $1.00 is invested in the NASDAQ 100, 43 cents goes into only 5 stocks, leaving the remaining 57 cents for the remaining 102 stocks. Is this diversification?

The S&P 500 index is also market cap weighted and the top ten companies (the 5 above plus Johnson & Johnson, Berkshire, JP Morgan, Exxon & Bank of America) comprise over 20% of the overall index. The top 53 companies comprise 50% while the bottom 250 companies are only 13.4% of the total. (see chart)

The Dow Jones index is a price weighted index. The higher a company's stock price, the larger impact it has on the index's movement. The market cap of the company does not matter. The top five stocks in the Dow (Boeing, Goldman Sachs, 3M, United Health and Apple) represent 33% of the index while the bottom five (Coca-Cola, Intel, Cisco, Pfizer and GE) are only



5.25%. General Electric has a market cap of 159 Billion equal to the largest Dow component Boeing. However because Boeing's stock price is $265.00 versus GE's $18.25, a 1% move in Boeing stock would move the index by 8% while a 1% move in GE would only cause a 0.50% move. Here's another kicker: The bottom five share-price companies have a combined market cap of $959 billion. The Dow components with the highest share prices have a combined market cap of just $791 billion, yet they have over six times the influence on the index.

With all of the money that has poured into passive index investing, an environment has been created in which poorly managed companies within a stock index can still see their stock prices rise along with well managed ones. The actual facts about a company do not mean much in a passive investing world. As investor dollars keep pouring in, the fund companies are forced to purchase the correct percentages of the underlying stocks in an index regardless of company fundamentals. An overwhelming portion of those dollars are needed to purchase the larger cap companies (Apple, Google, Amazon etc.) since they comprise a majority percentage of each index. It's no wonder the big companies are getting bigger and stock prices keep appreciating. Vanguard is one of the largest sponsors of Market index funds. This one fund company now owns more than 5% of 468 stocks in the S&P 500. That is a staggering figure.

It's hard to know how this new paradigm investing shift will end. Many have been "passive" and holding through the modest market downturns of the last few years. It's worthy of note as investments flow into index funds, certain stocks must be purchased in proportionately larger quantities which can accentuated their price increase. At the same time, we must be aware that in a declining market, as passive funds are liquidated, proportionately larger amounts of the heavily weighted stocks must be sold hereby accentuating the negative trend for those heavily weighted stocks.

Doug Geisser
VP FIXED INCOME PRINCIPAL

So are we worried? Not really. This so called "expert" has no idea of course when this might happen, but I do know that the failure of so many stocks to not only rise with the market but see their values decline this year offers us an opportunity to seek out and determine where there could be long term value.

Thank you for partnering with us on that journey and for your long term trust and confidence in us. Happy Holidays and best wishes for an extraordinary 2018.

Joe Romano,
PRESIDENT

SPOTLIGHT ON OUR CLIENTS

HOLLYWOOD COMES TO EVANSTON

Colleen and Joe in front of the Annie Mae Swift building at Northwestern University, where they met. Photo: Petra Korner

Colleen Griffen and Joe Chappelle, both award-winning producers, directors, and writers, have been clients of Joe Romano since 2010 and Evanston residents since 1995. Colleen and Joe met while working on their Master's in Fine Arts at Northwestern University. After years of working in the advertising industry, Colleen and Joe turned their focus back to filmmaking, with Joe directing and writing and Colleen producing their first feature, "Thieves Quartet." Colleen then took a break from the film world to stay home with their three children and spent time teaching at Columbia College and Northwestern. In 2013, Colleen wrote and directed her debut feature, the *Cold and The Quiet,* which won both Best Narrative and Best Direction at the Women's Independent Film Festival in Los Angeles. Over the last 15 years, Joe has worked exclusively with some of the most influential executive producers in the film and television industry: Jerry Bruckheimer on *CSI: MIAMI* (CBS/Paramount, David Simon on *THE WIRE* (HBO), JJ Abrams on *FRINGE* (Fox/Warner Brothers), and Dick Wolf on C*HICAGO FIRE* (NBC/Universal).

Their most recent project is an independent film written and directed by Joe and produced by Colleen called *The Pages.* The film is a female driven political thriller starring Jaime Lee Curtis, Tika Sumpter, Ben Tavassoli, and Jeff Hephner. The story is a politically tinged mystery of obsession, betrayal, and regret. The nation's top national security advisor, who harbors a dark secret, is stalked and threatened by nefarious forces as she endeavors to reveal the truth and achieve redemption. The Pages was shot in and around the North Shore, including Northwestern, the Central Street El Station, Clark Street Beach, Michigan Ave and Greenwood—and is coming to a screen near you in 2018. The folks here at Romano Wealth can't wait to check out *The Pages* and we hope you will too!

SPECIAL NEEDS FINANCIAL PLANNING

by Osman Arain

I jumped into the field of special needs planning after my first child was diagnosed with cerebral palsy in 2009. There is a tremendous amount of information to learn about special needs financial planning, and serious pitfalls exist that you can avoid with good advice. Disability is widespread; according to the US Census Bureau, in 2011 over 37 million Americans were classified as disabled: about 12% of the population.

I recently conducted a seminar in the western suburbs of Chicago for families with children with special needs. Roughly 25% of the attendees had done any sort of estate planning, and only one attendee had a special needs trust for her child. I explained to the attendees that not having an appropriate estate plan can be costly and put valuable government benefits at risk.

Whether we're talking about children with disabilities, mid-career professionals who find themselves disabled on the job, or elderly individuals who become physically and/or mentally impaired, these issues are widespread and ultimately affect all of our lives. Families dealing with disability have a greater need for financial advice and find themselves under more strain – both financially and along practical dimensions such as caregiving. We urge our clients to work with us as their financial advisors to make sure you are taking advantage of the opportunities available to receive help. If this rings true to you, please reach out to your Romano Wealth Management financial advisor for more information.

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ROMANO NEWS

ROMANO WEALTH 6TH GRADE FLAG FOOTBALL TEAM TAKES HOME THE BIG W!

For the second year in a row, Romano Wealth sponsored a team in the local Third Coast Flag Football league. This year was extra special as the 6th grade team RWM sponsored had not one but two Romanos involved: player Leo Romano (eldest child of Joe Romano) and assistant coach Valerie Romano, who represents the third generation of Romanos working at the firm! The team was able to rack up 8 regular season wins before claiming their final victory at the 6th grade Championships and finishing out the season undefeated. Congratulations, Meatballs!! (The team's self-selected nickname)