CARLSON CAPITAL MANAGEMENT

Quarterly NEWSLETTER

INVESTMENT INSIGHT

GREGORY A. CARLSON, CFP®, CEO AND FOUNDER

A Ten-Year Look Back

March 9, 2009, is an important day in our shared history. We didn't necessarily know it at the time as it took a few months for the significance of the day to reveal itself, but it was on this date when the financial markets hit rock bottom during the Global Financial Crisis (GFC). From that day forward the markets stopped their painful retreat and began to recover. That was ten years ago last month, and as we reflect on those ten years, of course there are countless learnings and insights that could be highlighted as related to the GFC as a whole. However, there are just a few related aspects that I wanted to focus on with this anniversary upon us.

Be wary of the numbers.

Since the market bottom in early 2009, investors in a globally diversified equity portfolio have realized 15.3% annualized returns[1] — returns well above historical long-term averages. At first glance, this is quite a tremendous run of performance. However, when we note that the 10-year timeframe begins at the very bottom month of the market low, we have context for that rate of return that is critical.

We want to help CCM clients be keenly aware that this time period can be used to craft narratives to fit a particular story. Some investors could point to this stretch of great performance as a reason why the market could be 'due' for a correction soon. Or, active asset managers could point to this time period as proof of their ability to deliver strong, above-average returns. Whatever the case may be, we must be astute and wise while viewing returns in context in order to make intelligent decisions.

[1] See source data referenced below the chart on page 2.

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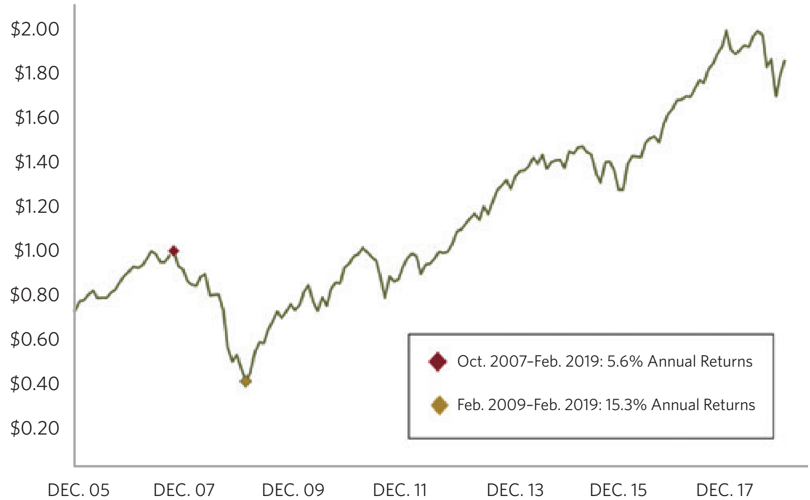
To illustrate this point, the chart on the right shows that if we were to look at that same globally diversified equity portfolio that has delivered 15.3% in annualized returns, but go back to October 2007 versus March of 2009 to evaluate performance, we would quickly see that it has delivered returns of just 5.6%. So, in a twelve year period which includes the market low, the returns are almost 65% less than what has been achieved over the past ten years *since* the low. The point being, a new story can be told simply by changing the time period analyzed, so we need to be careful not to draw conclusions from any one series of data. In the months that follow, we encourage you to be mindful of what you'll be seeing for 10-year track records—without context, return data can be very misleading.

GROWTH OF $1 — GLOBALLY DIVERSIFIED EQUITY PORTFOLIO



Data represents past performance. Past performance is no guarantee of future results. Chart is for illustrative purposes only. Returns are based on data from Dimensional Fund Advisors' Dimensional Equity Balanced Strategy Index. Specific components used are as follows: 20% S&P 500 TR Index; 20% Dimensional US Large Cap Value Index; 10% Dimensional US Small Cap Index; 10% Dimensional US Small Cap Value Index; 10% Dow Jones US Select REIT Index; 10% Dimensional International Marketwide Value Index; 5% Dimensional International Small Cap Index; 5% Dimensional International Small Cap Value Index; 3% Dimensional Emerging Markets Index; 3% Dimensional Emerging Markets Value Index; 4% Dimensional Emerging Markets Small Cap Index for the time period of December 2005 through February 2019. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio.

It was a painful, scary time…and we got through it.

CCM client portfolios were able to withstand that period in our history for the following primary reasons: discipline; setting aside 'safe money' as determined by the financial plan; and staying diversified.

- *Discipline* – CCM clients exhibited tremendous discipline during that turbulent time. Discipline presented itself in two primary areas. First, by reducing spending during a time of great volatility. There has always been volatility, but this was the first time during our (then 20) years of advising clients, that the economics of the moment raised a cautionary flag to reduce spending across the board. Second, CCM clients adhered to our shared investment philosophy. This was so critical that we expand on it further below.
- *Safe money* – A prudent financial plan starts with identifying, then making the appropriate allocation of dollars within the portfolio that need to be invested as 'safe' money. Safe, in this context, takes on two meanings. First, it means the underlying investment needs to be rock solid with very little risk, and second, it means there is a part of the portfolio that under all circumstances can be used to provide necessary cash flow. It is the counterweight to the growth part of the portfolio (stocks). At CCM, throughout the GFC our client portfolios contained short-term and high-quality fixed income—providing the greatest protection against principal loss.
- *Diversification* – In this context, diversification as it relates to belief in the global economy. Billions of people around the globe are buying/consuming goods and services—and always will. A diversified investment experience that participates in that flow—even with its ups and downs—will capture the long-term economic growth that persists. Clients benefited from staying diversified in portfolios owning more than 13,000 companies around the globe.

Successful investing requires staying disciplined to your investment strategy, through good times and bad.

As an illustration, consider the experiences of these two investors:

- Investor #1 – Before October of 2007, this individual invested in a globally diversified portfolio that held 60% stocks and 40% bonds, and didn't panic despite the tremendous turmoil in 2008. This individual's portfolio lost 38% from October 2007, to February 2009. However, the strong performance of global equity markets in 2009 and 2010 allowed the portfolio to grow and regain all of its lost value by December of 2010. By February, 2019, this investor saw a total cumulative gross return of 71%.[2]
- Investor #2 – This investor also held the same globally diversified portfolio (60/40 allocation) in October of 2007, however, the market volatility of 2008 was too much, and so they decided at the end of 2008 to sell all of their investments and remain in cash until the markets calmed down. This individual sat out for one year, re-entering the markets at the end of 2009. Sitting out just this one year prevented the portfolio from regaining its lost value until October 2013, nearly three years later than Investor #1. By February 2019, this investor saw a total return of 36%, roughly half of what was achieved by the disciplined investor example above.

What we observed in 2009, and in each of the years since, is that clients are best able to demonstrate this kind of critical discipline when they a) believe in their investment strategy, and b) have confidence in the financial plan that has been established for them with their advisory team. These reminders resurface as we see March 9, 2019 come and go, and think back on all that has transpired in those ten years. While many things have changed, one thing the GFC certainly reinforced is that sticking to the core, foundational tenets of prudent investing did not change, and served investors well.

Thank you for the privilege of serving you. Another reflection on this ten-year time period is that we weathered that time *together*. It is very rewarding to us to look back at how many of you were with us then and are still with CCM today.

[2] Dimensional 60/40 Balanced Strategy Index. Source: Dimensional Fund Advisors.

AT A GLANCE

FIRST QUARTER RETURNS

	Q1 2019	1-YEAR RETURNS	ANNUALIZED 5-YEAR RETURNS	ANNUALIZED 10-YEAR RETURNS
S&P 500 Index	+ 13.65	+ 9.50	+ 10.91	+ 15.92
US Large Value	+ 11.93	+ 5.67	+ 7.72	+ 14.52
US Small Cap	+ 14.58	+ 2.05	+ 7.05	+ 15.36
US Small Value	+ 11.93	+ 0.17	+ 5.59	+ 14.12
International Large Cap	+ 9.98	– 3.71	+ 2.33	+ 8.96
International Large Value	+ 7.92	– 6.13	+ 0.67	+ 8.12
International Small Cap	+ 10.65	– 9.36	+ 4.47	+ 12.76
International Small Value	+ 8.97	– 9.87	+ 3.32	+ 12.33
Emerging Markets	+ 9.91	– 7.41	+ 3.68	+ 8.94
US Short-Term Bonds	+ 1.23	+ 3.17	+ 1.26	+ 1.45
US Intermediate-Term Bonds	+ 2.94	+ 4.48	+ 2.74	+ 3.77

Data represents past performance. Past performance is no guarantee of future results. Chart is for illustrative purposes only. Returns are based on data from the S&P 500, Russell Investments for US indices, MSCI for international and Barclays for bonds for the time period of January 1, 2019 through March 31, 2019.

Specific indexes used for the table are as follows: S&P 500 TR USD; Russell 1000 Value TR USD; Russell 2000 TR USD; Russell 2000 Value TR USD; MSCI EAFE NR USD; MSCI Value NR USD; MSCI EAFE Small Cap NR USD; MSCI Small Value NR USD; MSCI EM NR USD; Barclays US Govt/Credit 1-5 Yr TR USD; Barclays US Agg Bond TR USD.

- Global equities experienced a strong rally in the first quarter of 2019 with the U.S. outperforming international markets.
- Small companies and growth companies outperformed large companies and value companies in the first quarter.
- Technology (19.9%), Industrials (17.2%) and Energy (16.4%) were the best performing sectors.
- Health Care (6.6%), Financials (8.6%) and Materials (10.3%) were the worst performing sectors.
- Fixed income had strong positive returns, due to higher short-term yields and falling long-term rates.

WELCOME AND CONGRATULATIONS CCM COLLEAGUES

We're happy to introduce TERESA ALT who has recently joined the team at Carlson Capital Management.

Teresa Alt, CPA

Tax Advisor

Rochester Office

University of Wisconsin – River Falls

In addition, we are pleased to share the news of a promotion for JAMES YAWORSKI. As a member of CCM's Investment Team, James is responsible for investment research, portfolio management and client investment education. He works with clients and advisors, providing in-depth portfolio analysis, leads investment-focused strategic initiatives, and is actively engaged in the on-going management of client portfolios. Congratulations James!

James Yaworski, CFA

Senior Investment Strategist

Rochester Office

Full colleague biographies can be read at *carlsoncap.com/team*

TAX CONSIDERATIONS

AN UPDATE FROM THE TAX TEAM: *Is Mortgage Interest Still Deductible?*

KEVIN KOSKI, CPA, PRINCIPAL TAX ADVISOR

Amongst many other changes we've highlighted in recent communications, the Tax Cuts and Jobs Act of 2017 changed the rules regarding home mortgage interest tax deductions for tax years 2018-2025. Many CCM clients have had questions about this so we wanted to share some key factors that will determine the deductibility of interest paid on a mortgage loan.

1. **The mortgage must qualify as *acquisition debt* in order for the interest to be deductible as home mortgage interest.** Acquisition debt is debt that is secured by the taxpayer's principal or second home, ***and*** was incurred in acquiring, constructing, or substantially improving the taxpayer's principal or second home.
2. **The amount of acquisition debt incurred after December 14, 2017, that qualifies for the home mortgage interest deduction is limited to $750,000.** For example, if you were to buy a $1,500,000 house with a $1,200,000 mortgage, only the interest that you pay on the first $750,000 in debt is deductible. The interest paid on a mortgage balance in excess of $750,000 is considered personal interest and is not deductible. For acquisition debt incurred prior to December 15, 2017, the applicable limit is $1,000,000. The debt limit is applied on a combined basis to the total acquisition debt on a primary or second home.
3. **The interest paid on new or existing home equity debt is not tax deductible.** Home equity debt is debt that is secured by the taxpayer's principal or second home ***and was not*** incurred in acquiring, constructing, or substantially improving the taxpayer's principal or second home. It is important to note that acquisition debt and home equity debt are terms defined by the Internal Revenue Code. The terminology used by the bank or mortgage company does not impact whether debt is acquisition debt or home equity debt. For example, a home equity line of credit used to substantially improve a taxpayer's home is acquisition debt and is not home equity debt. On the other hand, a first position mortgage used to pay off credit card debt is home equity debt and not acquisition debt.
4. **Interest on a refinanced mortgage is deductible as home mortgage interest subject to the rules above.** The applicable acquisition debt limit is based on the when old mortgage was incurred. For example, if the old mortgage was incurred prior to December 15, 2017, the refinanced mortgage is subject to a $1,000,000 limit. The amount of the refinanced debt that qualifies for the home mortgage interest deduction can't exceed the amount of the old mortgage balance prior to the refinance. In other words, a cash out refinance would not qualify.
5. **Home equity debt is not deductible as home mortgage interest, but may be deductible under a separate section of the Internal Revenue Code based upon how the proceeds were used.** Some examples of this include the following:
   a. If home equity debt was used to invest in stocks, the interest would be deductible as investment interest.
   b. If the home equity debt was used to fund an existing business, the interest paid would be deductible as business interest expense.
   c. If the home equity debt was used to purchase a rental property, the interest paid would be deductible against the rental income.

Changes in the home mortgage interest deduction significantly impact the analysis of many important financial planning decisions. We are assessing how these changes may affect your integrated wealth plan. Please contact us if you have any related questions.

Tax Updates featured in previous newsletters can be found at ***carlsoncap.com/articles***

PLANNING FEATURE: *Reading the Fine Print — Optimizing Your Employer's Retirement Plan to Shelter Income and Create Tax Diversification*

MATTHEW RICH, CFP®, J.D., INTEGRATED WEALTH ADVISOR

When new office employees are starting a new job, they often go through the same routine. The first few days are spent locating the breakroom, finding a good parking spot, and orienting to the cultural norms. Then there's the meeting with human resources—you get a key card, complete payroll deduction paperwork, and review compliance documents. Dental insurance? Extra life insurance? How much should the company take out for 401(k) contributions? Pre-tax or after tax? Most people go with the flow. The quickest and easiest answers are the ones first deployed. The price of ease, however, is often missed opportunity.

Employer-sponsored retirement plans come in many different flavors. Contribution and distribution options, investment choices, fees, and tax-deferral opportunities are generally plan specific and vary significantly among employers. Plan administrators must provide its plan participants with detailed documentation for each plan. For most retirement plans, this is in the form of a Summary Plan Description. These documents are often a gold mine for optimization opportunities, so it's critical to review and understand the provisions within.

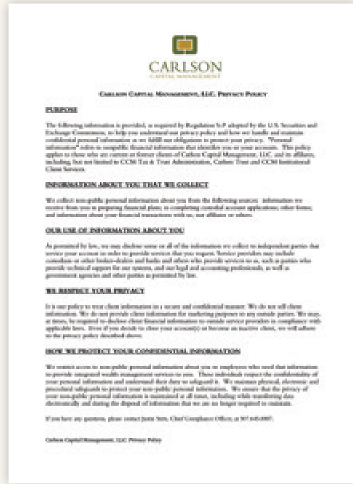
With the following two examples, my hope is to illustrate the importance of knowing and understanding the plan documents:

First, we always want to know if a retirement plan allows for participants to roll outside money into the plan. For example, a new employee may have worked at a previous employer and has either a 401(k) tied to the former employer or moved those old 401(k) assets to a rollover IRA. It's helpful to know if the employee's new 401(k) will accept those assets. That seems like a small detail, so you might wonder why it would matter at all. Well, let's assume that the employee is approaching age 70 and still going strong at work. The employee is passionate about the work, doing a great job, and earns a healthy salary. Although the employee's new 401(k) account will be unaffected when the employee turns 70, any money left in an old 401(k) or rollover IRA will be subject to the required minimum distribution rules, meaning a percentage of those accounts must be distributed and treated as ordinary income for tax purposes. The tax consequences might be quite severe if the employee is still working and earning substantial income. Wouldn't it be nice if the employee could, instead, move all the old assets into the new plan to avoid those required minimum distributions (and the taxes) while still employed? The Summary Plan Description for the new 401(k) will tell us if it's possible.

The second example is a strategy that is underutilized, but can save significant tax dollars in the future. Most mid-size or large companies offer the traditional 401(k) option. Some go a step further and also offer a Roth 401(k), wherein employees contribute post-tax dollars to be invested and grow tax-free. In some cases, employers even include plan provisions allowing for "after-tax" contributions to the plan. These contributions are distinct from Roth 401(k) contributions, and the IRS contribution limits for after-tax contributions into a retirement plan are considerably higher than 401(k) contribution limits or Roth IRA limits. In some cases, for example, it's possible that an employee can put $30,000 per year into the plan as an after-tax contribution. If the plan also offers the flexibility of "in service rollovers," that same employee can then roll those "after-tax" funds to a Roth IRA account. After the rollover, those funds would then grow tax free within the Roth. While most people are limited to Roth contribution limits of $6,000, our example employee managed to make a $30,000 contribution to a Roth account simply by fully understanding and optimizing the retirement plan provisions.

Advisors at Carlson Capital Management have experience working with all types of retirement plans, and we're constantly reviewing plan documentation looking for optimization opportunities for our clients. Feel free to connect with your advisor directly if you have any questions about your retirement plan and the related opportunities that may exist.

ANNUAL PRIVACY POLICY AND FORM ADV



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INFORMATION ABOUT YOU THAT WE COLLECT

OUR USE OF INFORMATION ABOUT YOU

WE RESPECT YOUR PRIVACY

HOW WE PROTECT YOUR CONFIDENTIAL INFORMATION

Enclosed with this quarter's report you'll find CCM's Privacy Policy which we provide to you on an annual basis. In addition is an annual notice of what constitute material changes to our Form ADV Part 2A Brochure. The Form ADV Part 2A Brochure is a document that is updated annually and that all investment advisers are required to file with the U.S. Securities Exchange Commission. We provide you with a summary of material changes as a means of keeping you informed. You will note that there were no material changes made to CCM's ADV this year.

The full Form ADV Brochure and Supplement as well as our Privacy Policy are always available to you. The Privacy Policy is online for review and the ADV can be requested at any time, both at ***carlsoncap.com/ADV.*** These documents are also saved in your Client Portal and are available by phone request.

CCM PRINCIPALS RECOGNIZED AS *Five-Star Wealth Managers*

Gregory A. Carlson, CFP®, Justin D. Stets, AIF®, Jeffrey R. Carlson, CFP®

CCM has been recognized in the Five-Star Wealth Manager award program, with each of CCM's three principals included as 2019 winners. Featured advisors are highlighted in the January editions of *Mpls. St. Paul* and *Twin Cities Business* magazines.

(Ranking disclosures on page 8.)

YAWORSKI PUBLISHES *Spending Policy Research*

We are excited to share the news that the second quarter 2019 edition of the *Financial Analysts Journal*, published by the CFA Institute, includes a research paper written by James Yaworski, CFA, Senior Investment Strategist at CCM.

Through this research, James sets out to provide institutional investors with a more robust way of constructing spending policies. He shows how current practices create poor long-term outcomes, resulting in declining support for beneficiaries over time. He also demonstrates how current methods expose trustees to significant fiduciary risk, and how small errors in implementation can have significant long-term ramifications on portfolio growth.

In the paper, James lays out the framework for the construction of more efficient spending policies, which enhances an organization's ability to achieve long-term goals while greatly reducing the fiduciary risk to which trustees are exposed. Yaworski's in-depth and thoughtful research stems from his genuine interest in providing university, public and private foundations, and endowment trustees with an approach that not only optimizes the outcomes of their portfolio's performance, but also addresses their fiduciary responsibility with regard to spending policies. The paper should be of interest to trustees, beneficiaries, and donors who wish to ensure the sustainable management of endowed gifts.

> *"My hope is that this paper will have a significant positive impact on the non-profit community, providing guidance to trustees of endowments and foundations on how they can improve the stewardship of endowed assets."*
>
> — JAMES YAWORSKI, CFA

"My hope is that this paper will have a significant positive impact on the non-profit community, providing guidance to trustees of endowments and foundations on how they can improve the stewardship of endowed assets," stated Yaworski.

Carlson Capital Management President, Justin Stets, AIF®, said, "This research breaks new ground as James has created a new seat at the endowment table – that of the donor. The voice of the donor is honored when institutions fulfill their obligation to do everything in their power to ensure that an endowment gift retains its inflation-adjusted purchasing power. James's work attends to that obligation, which is borne by the fiduciary status of board members. Every trustee in the country who is responsible for the stewardship of endowment dollars should read and act upon this research."

Stets continued, "The voice of the donor shines through in this paper. Foundations and non-profits now have an ability to stand before both their donors and their trustees to announce that they have a better tool to track the true growth of donor contributions."

The *Financial Analysts Journal,* a publication of the CFA Institute, aims to be the leading practitioner journal in the investment management community by "advancing the knowledge and understanding of the practice of investment management through the publication of rigorous, peer-reviewed, practitioner-relevant research from leading academics and practitioners."

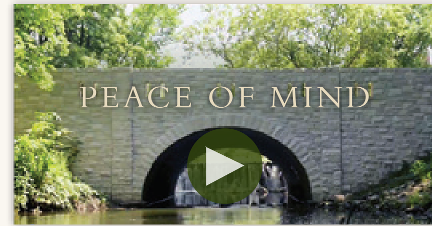
For access to the paper and to view a short video of James's research overview, visit: ***carlsoncap.com/spending-rate-rule***

COMPANY NEWS & COMMUNICATIONS

JASON KLEY, CFP®, AIF®, MBA, CCM Senior Integrated Wealth Advisor and Director of Planning, recently testified before the Finance and Policy Committee of the Minnesota Senate about the importance of financial literacy for the state's youth. The related bill, which advocates for a financial literacy graduation requirement in Minnesota, has advanced and is now up for consideration.

In January, CCM COLLEAGUES visited Duluth Pack (in Duluth, Minnesota) where we were able to see products being hand-crafted by Duluth Pack employees and learn about the history, culture, and quality standards of the 137-year-old local company. The visit and tour were part of a holiday gift from CCM, and all colleagues received beautiful custom-ordered Duluth Pack items following the trip. *duluthpack.com*

CCM FILM SERIES: ENRICHING LIVES



VISIT ***carlsoncap.com/video*** for insights shared by CCM COLLEAGUES on what our work with our clients means to all of us.

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