(Annual mutual fund guide: What you need to know)

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MORNINGSTAR REPORTS

The retirement income dilemma and what to do about it

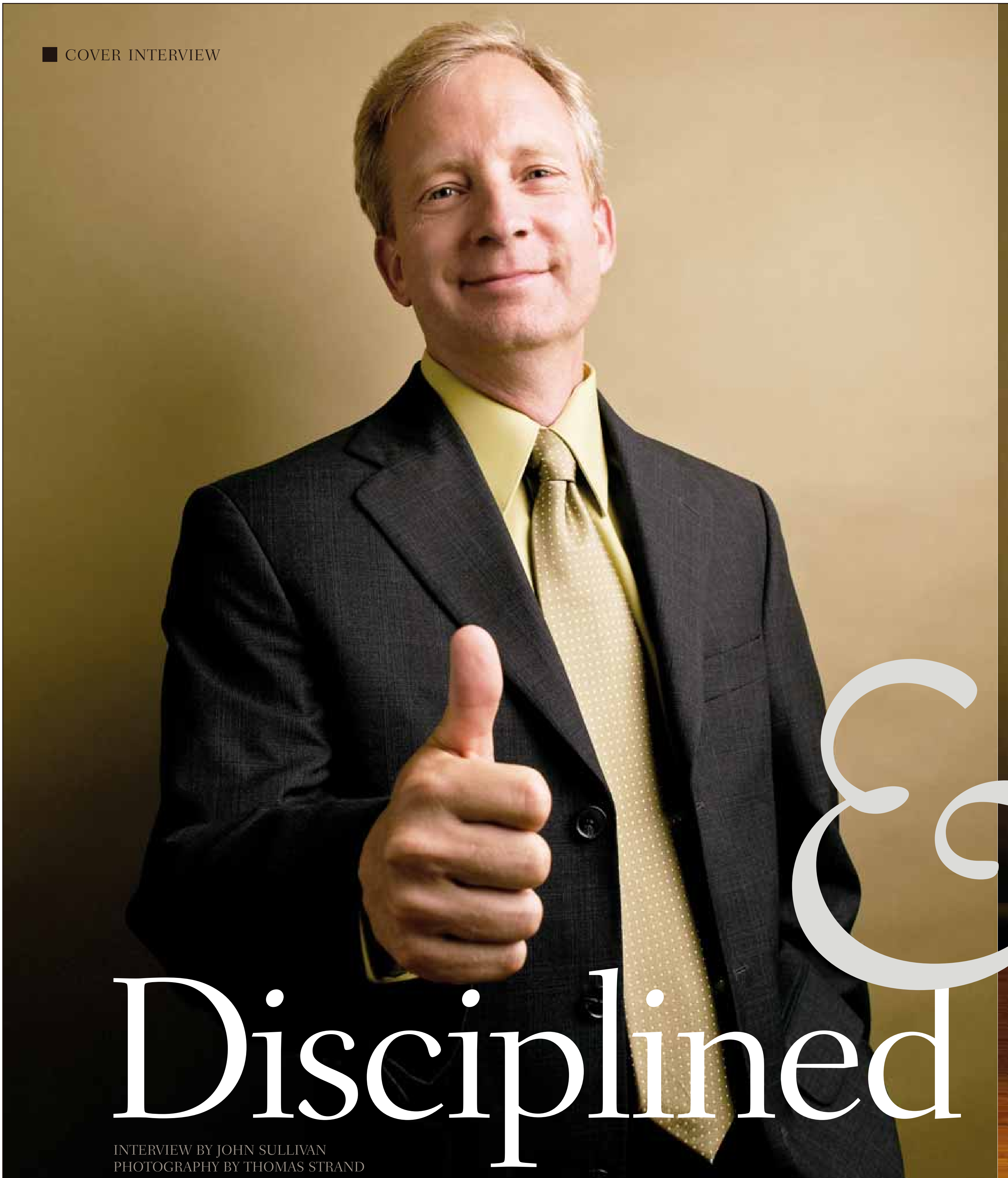
LIPPER'S TOP TAX-EFFICIENT FUNDS

THE VICE FUND

takes on socially responsible investing

"Be disciplined, be diversified, be tax efficient"

How Greg Carlson hit half a billion dollars in assets under management (and what it's like to work with Dimensional Fund Advisors)



Disciplined &

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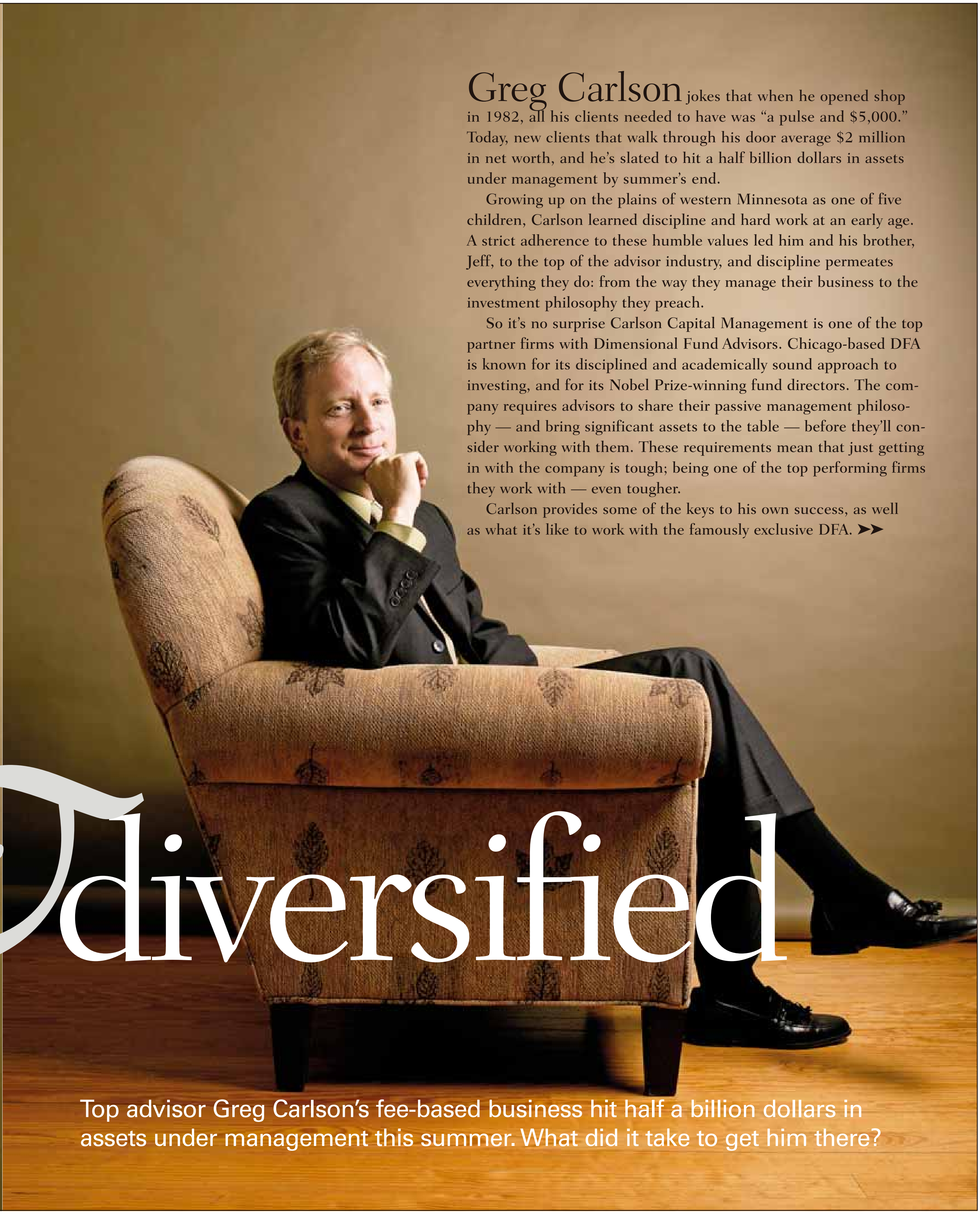

Greg Carlson jokes that when he opened shop in 1982, all his clients needed to have was "a pulse and $5,000." Today, new clients that walk through his door average $2 million in net worth, and he's slated to hit a half billion dollars in assets under management by summer's end.

Growing up on the plains of western Minnesota as one of five children, Carlson learned discipline and hard work at an early age. A strict adherence to these humble values led him and his brother, Jeff, to the top of the advisor industry, and discipline permeates everything they do: from the way they manage their business to the investment philosophy they preach.

So it's no surprise Carlson Capital Management is one of the top partner firms with Dimensional Fund Advisors. Chicago-based DFA is known for its disciplined and academically sound approach to investing, and for its Nobel Prize-winning fund directors. The company requires advisors to share their passive management philosophy — and bring significant assets to the table — before they'll consider working with them. These requirements mean that just getting in with the company is tough; being one of the top performing firms they work with — even tougher.

Carlson provides some of the keys to his own success, as well as what it's like to work with the famously exclusive DFA. ➤➤

diversified

Top advisor Greg Carlson's fee-based business hit half a billion dollars in assets under management this summer. What did it take to get him there?

BMA: Passive management took a hit in the late 1990s, but its performance through the market downturn was something of a vindication. When you started your firm in the 1980s, did you immediately go with the passive approach?

GC: No. Certainly our approach was disciplined and diversified, but it was disciplined and diversified using actively managed funds. It was about 1997 that we went with DFA, and began using their investment products. We've always done things the same way; we've just gotten much better at how we implement the strategies. It's been a constant fine-tuning: more experience, more wisdom. Our work with the passive concept is probably just short of 10 years.

BMA: So how did you come through the latest bull-bear cycle?

GC: The beauty is that we adhered to the passive principle throughout. In 1997, 1998 and 1999, on an absolute basis, we were under-performing in people's minds. But in 2000, 2001 and into 2002, we were over-performing. Quite frankly, it isn't over-performance, it's just "It is what it is" based on our philosophy. I think that's one of the strong stories we have. We stayed disciplined and true through the two markets.

BMA: I'm sure many of your clients were seeing their neighbors get a 200 percent return in Janus Overseas, so I suspect it was difficult to convince them to say consistent. What role did behavioral economics play?

GC: We have very strong relationships with our clients. Certainly return is an important factor, but I wouldn't characterize it as extremely difficult. We had a little bit more explaining to do. We had to educate our clients on why we were staying disciplined and why we were not highly concentrated in areas that had grown so quickly and had such robust returns.

BMA: What is your client retention rate?

GC: Ninety-nine percent.

BMA: Tell us how you started out and about the evolution of your investment philosophy.

GC: I graduated from St. Olaf College here in Minnesota in 1982 and went right to work for IDS American Express. I stayed with them until 1986. In the summer of 1986, I went independent with FSC Securities Corp., more in the commission-type environment; from 1986 until about 1991. My brother and I formally got together in 1987, although it wasn't called Carlson Capital Management at that point. That's really the genesis. It was about 1991 or 1992 where we started to transition into the fee-based business and out of commission. We were early on in that process, quite frankly.

BMA: How difficult was it to make that switch to fee-based?

GC: It wasn't overly difficult at the time because we didn't do it all at once. We started recognizing it made sense with some of our larger accounts, so we gradually grew into it. It took two or three years to fully make the transition. We were always implementing these diversified strategies, but it wasn't until 1997 that [it] really solidified with a passive approach.

BMA: It seems that a lot of what Carlson has become emerged in the past few years.

GC: Yes. We've grown an average of 25 percent a year for the last 10 years, and that 25 percent gets to be in a larger base and more significant. It's exponential. We've had a tremendous amount of growth. We've more than doubled in the past three years.

BMA: What about the structure of your firm? How many offices do you have?

GC: We're an integrated wealth management firm with three offices in Minnesota. We have 12 employees and three principals, which are myself, my brother Jeff and my brother-in-law Justin. In addition to that, we have three senior planners that are connected with each principal and two CPAs. One of the CPAs is also a senior planner and has a dual role. We have an attorney and five CFPs. We have a chief investment officer, an operations technology person and three support staff. We prepare tax returns for most of our clients and only for our clients, so we did about 350 tax returns last year. We manage and administer charitable trusts through a tax and trust administration entity within our structure. In addition to that, established Carlson Trust Company, a division of National Independent Trust Company, through which we provide personal and corporate trust services under a unique platform. Lastly, we seeded and funded the Minnesota Center for Philanthropy, a non-profit organization. It was designed to provide for a lot of the philanthropic aspects of our clients' overall

wealth management strategy. Primarily [this works with] donor advised funds. So overall our firm is really a one-stop shop.

BMA: Many advisors hold themselves out as part of a wealth management team for high-net-worth clients. Is that something you shy away from? Would you rather have it all in-house?

GC: Well, that's a great question, because that's historically how we've done it and that's how we are doing it right now. It's not that we always thought we were better than other strategic partners, but we just found that we control the experience much more when we do it in-house. So for the most part, we will keep it in-house and totally embrace our client and encircle our client in a way that all of their needs are facilitated though us.

BMA: You won't have to deal with the egos either.

GC: Well, as I've said, we've had some good strategic partners on the tax side, or the administration side in the past; good people, good firms. But it is just so helpful to control the total experience.

BMA: The family office structure is getting a good deal of attention lately. How successful have you been in getting the assets of you clients' children and grandchildren?

GC: I think we do a very good job at that, however, our firm's strength, our target market, is between $1 million to $25 million. Our real sweet spot is $2 million to $10 million. I think the family office structure is probably north of that. I think we already provide what family offices do through our structure already. But we haven't formalized it. We haven't marketed ourselves that way.

BMA: How did you become aware of DFA?

GC: Through a colleague that introduced us. They'd been successfully using them so we did our research and due diligence and it made a lot of sense to us. They were reaching out [to] independent advisors at the time, but it certainly was a much smaller part of their businesses than the institutional side. At that time, the advisor community was maybe 10 percent of their business. Now I think it's something like 60 percent, if I recall. It's been quite a jump. I think they've always reached out to the individual advisor, but they've been much more intentional about growing this part of the market in the past three or four years.

BMA: What are some of the benefits of working with them?

GC: First and foremost, we believe in the passive approach. Secondly, if you believe in that approach, you have to determine how it is that you are going to implement that strategy. What I've always appreciated about DFA is that there's the academic research and there's the market intelligence behind it. It's always consistent. It's not like they're chasing things. They are not going to let shifting markets and emotional behavior dictate the moves they make. I use the word pure; you know what you are getting with them is pure, both with the asset classes when you purchase them, but also with the people behind it and the structure and institution. There are no surprises. One thing I've learned in 23 years in the business is to pick your partners well. You don't want to have any unacceptable outcomes. You want people that tell the truth and stick to the truth. [DFA is] disciplined and transparent and the cost structure is fair. You're not being marketed to. They say, "Here's the information. Here's the data. Here's our philosophy. Now, Greg Carlson at Carlson Capital Management, if you agree with that, go ahead and implement our strategy." They're not trying to convince me of anything. They let me decide.

BMA: What do they normally require you to bring to them before they'll work with you?

GC: You have to have a certain level of assets, somewhere in the neighborhood of $10 million to $20 million. They want to work with advisors that have a deep relationship with their clients. They don't want to be working with an advisor that has clients that are running hot money, in or out. They don't want to see a lot of trading going on because someone might be timing the market. You can't have any of that to speak of. So it's not so much an asset thing, but more of a culture and philosophy. You either believe in the philosophy or you don't.

[Editor's note — DFA clarifies by saying a significant amount of assets are required after the first year, but they do work with advisors who begin with no assets under management.]

BMA: How familiar were you with Modern Portfolio Theory and with Dr. Markowitz's work prior to partnering with Dimensional Fund Advisors? What kind of learning experience has it been?

GC: I was certainly familiar with MPT. Quite frankly, as you are growing your business, you're working on the marketing side and bringing in new clients as opposed to digging in to the investment side.

BMA: Just trying to keep the lights on.

GC: Exactly. But our chief investment advisor has dug into it very deeply. He understands both their side of the equation in terms of what they are trying to do from an academic standpoint, but he also understands it from the business side. He's been extremely good at helping us to understand and articulate modern portfolio theory, but also it's place in the passive strategy. You can incorporate modern portfolio theory into active management. So, we certainly had an understanding about portfolio theory prior to DFA. They did not introduce us to modern portfolio theory. They just introduced us to how they execute and implement modern portfolio theory by using their asset class products.

BMA: **Too often, people confuse indexing with asset class investing. Please explain the difference and why that difference is important.**
GC: One of the ways we describe it is when you index, you are in essence a slave to the rules that have been set up for that particular index, as opposed to when the investment is made in the asset class. DFA has a certain buy range. They can hold an individual stock within that asset class perhaps longer than an index can. By being able to have that type of latitude, it doesn't change significantly the character or the nature of the return of the risk dimension of that asset class, but it can make it more tax efficient and more cost effective. With certain asset classes, you can be even more refined than an index. By refined I mean that if you want to get small or you want to get a more value tilt, some indexes don't let it happen. So, that's one of the benefits we've found with DFA. They are able to develop the strategies with asset class funds that match the academic research that we use to then construct client portfolios. Their small might be smaller or their value might be more valued than the other indexes that we see.

BMA: **We notice that you're not pulling back from real estate, which is the opposite of what we're hearing from other advisors. Why is that?**
GC: We're getting out of the REIT market to a certain extent. What we've done is we've taken a significant amount of assets out of DFA's real estate fund and we've put it into our real estate holdings over at TIAA-CREF's real estate fund. The REIT fund we invest in at TIAA actually physically owns most of the property. It's more of an income stream investment and it's a hybrid between a stock and a bond, if you will. It's got significantly less volatility for a variety of reasons. We are quite concerned about the REIT market. We still want to be in real estate. We want to hold the same 4 percent allocation in a 60/40 portfolio, but we've changed somewhat how it is we are implementing that strategy. All we are doing is constantly rebalancing the portfolios back to the allocations. If our real estate is doing extremely well, which it did, instead of a 4 percent allocation on a 60/40, it's now up to 5.5 percent and we're putting it into areas that have under-performed.

BMA: **They don't mind that you went with TIAA-CREF?**
GC: DFA are great partners. I continue to expect that they will be great partners. I don't have to look behind my back. I don't feel that at all. But if I'm truly doing my job for my client, and if I am objective, I can't necessarily say tomorrow I'm going to be with DFA. But I think I will.

BMA: **What is the Zero Alpha Group?**
GC: Zero Alpha Group consists of eight firms that collectively manage about $3.7 billion. Its genesis was guys getting together that had a common investment methodology. It primarily revolved around DFA funds. It's not exclusively DFA funds, but the highest percentage of the assets is in DFA funds. We physically get together three times a year and a number of times via telephone and correspondence. We share best practices for running a business and market intelligence and wisdom. It's a unique group because there are no secrets among any of us. I can ask any one of my colleagues anything about their business and they will share it. Likewise, I will share with them, whether it's my salary, my profitability, how much I'm paying for marketing, what I'm paying for computers, what I'm paying my senior planners. Everything is an open book. We do not compete. I think one of the reasons it works is because we don't compete in each other's markets.

BMA: **From an advisor's point of view, what do you think are the top three issues affecting the industry?**
GC: Well, one of the larger issues we have to deal with is the issue of growth. How do you handle growth, being able to provide the same level of service and quality when you have new clients coming in? That's one of the challenges we face.

BMA: **You maintain that growth in both up and down markets?**
GC: We probably grew more in the down market than we did in the up market because [of] our diversified approach. In 2001 and 2002, when there was tremendous blood shedding, we didn't quite break even. We broke even on our typical 60/40 portfolio, so that goes a long way in people's minds and has a positive effect. In 2003, our diversified portfolio was up by 28 percent. We've just been very solid. People's memories are short. They don't remember on an absolute basis that our numbers weren't as good in 1998 and 1999 when the tech boom was going on. What they do remember is the last five years. I suspect that if in the next five years that there's a certain sector boom and everybody goes to it and we don't, they'll start thinking about us in that context. But what we've been able to accomplish is to convince people to take their eye off the rate of return. We've been very effective at managing expectations and the overall client relationship.

BMA: **What does the near-term future hold for Carlson Capital Management?**
GC: I think we'll get better every year, and it's a function of time and experience. You can only get experience with time. You only get wisdom with time. We used to be 80 percent [passively] pure. Now we're 92 percent pure. The only reason I'm 12 percent more pure is because I'm just a little bit smarter and I hope to get smarter every year. What we're doing is not rocket science. If you go to a medical doctor, he can tell you three things. If you just exercise, eat well, and sleep well you're likelihood of being healthy goes up exponentially. It's the same with us. Be disciplined. Be diversified. Be tax efficient and cost conscious. Save some money and don't spend foolishly. If you do those five things, you'll be successful. b