

## AN INVESTMENT FOR EVERYONE?

By Tom McIntire, CFP®, CLU®, CFA



Tom McIntire,  
CFP®, CLU®, CFA

Imagine five 95-year-old women who are interested in creating an investment club, but a club that is different from the usual kind. Each woman

invests \$100 in a pool, but only survivors at the age of 96 will split the proceeds. While they are waiting to reach their 96th birthdays, the five women decide to put their \$500 pool into a local bank certificate of deposit (CD) paying 5 percent interest for the year.

According to statistics compiled by the Social Security Administration, there is roughly a 20 percent chance that one member of the club will die during the next year. Nearly anything *could* happen to the women in that year of waiting, but on average, four will survive to split the \$525 pool at year end. Thus, each survivor will receive \$131.25, a 31.25 percent return on the original \$100 investment. Put another way, each receives a 5 percent return on the CD investment and \$26.25 person of “mortality credits.” These credits represent the capital and interest “lost” by the deceased member and “gained” by the survivors.

The catch, of course, is that the non-survivor forfeits her claim to the funds. Although the heirs of the deceased may be frustrated with the outcome, the four survivors receive a superior investment return with little investment risk. More importantly, all

of them are able to manage their lifetime income risk, in advance, without having to worry about what the future may bring.

Let’s take the story one step further by supposing the club decides to invest the \$500 in the risky stock market instead of a less risky CD. What happens if the value of the stock *falls* 20 percent during the next year? How much will the surviving members lose? If you think the answer is “nothing,” you are correct! The four survivors divide the \$400 among themselves, so each receives her \$100 back. Such is the power of mortality credits, which subsidizes losses on the downside and enhances gains on the upside. In fact, one can argue that when adding this kind of “longevity insurance” to a diversified portfolio, an investor (or annuitant) can actually afford and tolerate more financial risk.

But, don’t try this at home! This money transfer scheme, called a “tontine”, where all money contributed to a pool is given to the last survivor(s) of the pool, is illegal in the United States because it creates an incentive to murder your co-investors. The tontine, however, illustrates the basic mechanics of a single premium life annuity that an insurance company can create for you.

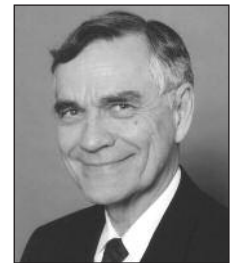
Decades of economic research starting with Menachem Yaari in 1965 have pointed to life annuities as a major component of optimal retirement plans. Yaari showed that a retiree with no desire to leave a bequest should annuitize *all* retirement savings. In 2005, Thomas

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## THE SUB-PRIME MORTGAGE DEBACLE

By Joe Mattei, CFP®

With our unsettled economy, the sub-prime mortgage situation has been one of the main causes for volatility and



Joe Mattei, CFP®

uncertainty in the stock markets this past year. This relates to financial planning because until the end of the sub-prime mess becomes clearer, I suggest a continued cautious approach to investing.

### Recipe for Disaster

The “sub-prime mortgage debacle” comes from a recipe of mistakes and bad judgment:

- Step 1:** Start with excessive greediness by Wall Street.
- Step 2:** Mix in a combination of a housing bubble (prices going up rapidly and a belief that they could only keep going up), easy credit (low interest and mortgage rates) and lax lending standards.
- Step 3:** Add some “financial innovation” (derivatives, leverage on mortgage notes) that are now being stress-tested – and found wanting. To paraphrase Warren Buffet, “derivatives are a time bomb waiting to explode.” The main problem with securitization and derivatives (re-selling the mortgages) is it gave lenders (banks and brokerage houses) less reason to care whether borrowers

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# PRESIDENT'S LETTER SPRING 2008



**Bill E. Carter,**  
CFP®, ChFC, CLU®

## “A FINANCIAL DISASTER” AVOIDED

The first quarter of 2008 was one of the worst for the U.S. stock market over the last two decades;

the culprit was a liquidity crunch of gigantic proportion. While there was a substantial amount of write-downs over the last six or seven months, no one, yet, can put a dollar figure on the total cost related to reducing the book value of these assets because there are probably more to come.

Was this liquidity crunch a financial crisis? At last year's Carter Investment Conference, I talked about the debt associated with mortgages, not just sub-prime. I related that no one knew the scope of the problem. Until we did, the markets would be very choppy, going up on good news and coming down on bad news. In fact, in my last President's Letter, I said, *“The bottom line is that I think it will be a very choppy and difficult market for the next six and maybe even eight months. However, if we are lucky, and it will take some luck, the last quarter could be very positive.”*

Unfortunately, today, we still do not know where the bottom is, but as we continue to see write-downs of debt, I think we are getting closer to the end of this mess.

How did we get here? I would like to refer you to Joe Mattei's article, “The Sub-Prime Mortgage Debacle” in this newsletter. In simple terms, Joe does an excellent job explaining how this very complex mess came about. As Joe says, there is a lot of blame that is appropriately spread around. The root cause of this credit crunch is the securitization of mortgages. In other words, the packaging of mortgages into securities that were sold as investments.

Have we experienced a real crisis since the beginning of the year? Consider these somewhat revolutionary actions taken by the Federal Reserve:

- This last quarter, the Fed dropped interest rates 75 basis points – the *largest one-time cut* since August 1982 when the interest rate was lowered 100 basis points.
- The Term Auction Facility (TAF) and Term Securities Lending Facility (TSLF) were created. Under the TAF, the Fed will auction term funds to depository institutions. All depository institutions that are eligible to borrow under the primary credit program will be eligible to participate in TAF auctions. Through the TSLF, the Fed will lend up to \$200 billion of Treasury securities to primary dealers, secured for a term of 28 days by a pledge of other

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*“Dallas and Houston  
enjoyed two of the strongest  
economies in 2007  
of any metro areas across  
the country.”*

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securities. These securities include federal agency debt, federal agency residential-mortgage-backed securities (MBS) and non-agency AAA/Aaa-rated private-label residential MBS.

- The Fed opened the discount window to non-depository investment banks, negotiating a buy-out of Bear Stearns that helped the company from declaring bankruptcy.

This is pretty strong medicine, so I think it is safe to say our financial markets were, if not in crisis, pretty sick.

The obvious question is, “Where are we today?” To begin, the financial markets are not well, but it does

appear the actions of the Federal Reserve worked. While the economy is still somewhat fragile, I think we are through the worst of the credit crisis, barring any other unforeseen event. It is important to understand the magnitude of this problem and that it will take some time to unwind.

It appears Fed Chairman Ben Bernanke's actions were exactly what the markets needed. Even though he was criticized for not recognizing the scope and depth of the liquidity crisis soon enough, when he finally did understand the problem, his actions, in my opinion, were brilliant. Even though I think much of the difficulties we have seen in the markets could have been averted if he had taken action earlier, that is just water under the bridge.

This is not the first financial crisis we experienced. As I counted back over my 35 years in this business, I have witnessed somewhere around 10 or 11 financial crises. You may remember the savings and loan crisis in the 1980s; remember the “see through” office buildings and apartment complexes that were ultimately torn down, as well as the creation of the Resolution Trust Company? That was certainly a time of financial crisis for financial institutions, and Texas was one of the states that suffered the worst.

This time, one of the key differences is that the overall Texas economy has not been greatly impacted by this financial crunch. We have seen record bankruptcies in the state and in the Dallas area, but, overall, the state is in very good financial condition. In fact, Dallas and Houston enjoyed two of the strongest economies in 2007 of any metro areas across the country.

There were other crises, too. The difficulties in the late 1990s in Asia – the “Asian Contagion” – had a very negative effect on the markets and was a real threat to the world economy. Additionally, in August 1998, the Russian Central Bank lost support of the ruble from the International Monetary Fund. As a result, the

Exchange Rate fell 38 percent *overnight*. The impact on the U.S. economy was very negative; the Dow lost more than 1,000 points, which at that time was 12 percent of its value.

In addition, there were problems with Long-Term Capital Management (LTCM), a New York hedge fund. At the time, LTCM developed a computer program it felt would prevent it from ever losing any money. Whoops! That concept failed and LTCM lost millions of dollars. The investors at that time were primarily large institutions and very wealthy. Fed Chairman Alan Greenspan, along with President Clinton’s Secretary of Treasury Robert Rubin, helped engineer a rescue for LTCM where there was a capital infusion by several large financial institutions.

The reason for this unprecedented move by Greenspan was that he did not know how many other companies with problems just like LTCM were in the marketplace. With several of the money center banks already in trouble with their loans to Russia and Southeast Asia, Greenspan was afraid that if LTCM collapsed, there might be several others just like it who would also fail. Greenspan was concerned that if other hedge funds were to go down, they could take down one of the money center banks. The consequences would have been devastating to the financial markets.

At the time, I remember thinking how unfair it was that the Fed would

rescue these big institutions and very wealthy investors, thinking that was something they would not do for *my* investors. Well, it did not take long for me to realize that Greenspan was trying to prevent the failure of one or more of the money center banks – again, the results of which would lead to a true financial crisis. The actions

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*“Combined with the stimulus tax package passed by Congress, there will be a substantial amount of incentives added to the economy over the next several months.”*

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taken by Bernanke to arrange the purchase of Bear Stearns by Morgan Stanley was similar to Greenspan’s actions. Bernanke has come under strong criticism, again, for bailing out a corporation. However, in his testimony to Congress, he stated he felt his actions were needed to avoid an economic meltdown. An “economic meltdown” ... I would suggest those are pretty strong words coming from the chairman of the Federal Reserve.

As I said earlier, the actions taken by the Fed have settled down the credit markets, but again, it will take some time for all of this to unwind. With

interest rates cut, one more cut may be coming. Combined with the stimulus tax package passed by Congress, there will be a substantial amount of incentives added to the economy over the next several months.

Although it’s hard to gauge whether the stimulus package will really have much of an impact, it will probably help. At some point, the lower interest rates and the money put into the system will begin to have a positive effect. We will see the economy stabilize and start to grow again. Over the shorter term – the next five to six months and probably until the election – I think the markets will stay very choppy and, in all probability, will continue to trend down. As I write this letter, we are in the midst of a mini-rally, but I do not think it will last. It would be nice and surprising if it did!

When will the market turn up for good? Well, that is something everyone would like to know. I do not know when the market will stabilize and begin to move back into a growth mode, but one of the things I have learned through the years is that the markets always turn up prior to me thinking they will. Markets generally turn up when the news continues to be bad. I have watched this time and time again. When the markets finally stabilize and turn up, people always think it is a false move because there were generally a few similar situations leading up to the real recovery. Again, market recoveries seem to always

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<b>FINANCIAL TRENDS</b>	<b>3/30/07</b>	<b>6/29/07</b>	<b>9/28/07</b>	<b>12/31/07</b>	<b>3/31/08</b>
Dow Jones Industrial	12,354.35	13,408.62	13,895.63	13,264.82	12,262.89
NASDAQ	2,421.64	2,603.23	2,701.50	2,652.28	2,279.10
NAREIT Composite	200.47	180.93	179.41	155.60	152.76
Russell 2000	800.71	833.69	805.45	766.03	687.97
MSCI-EAFE	2,147.51	2,262.24	2,300.37	2,253.36	2,038.62
Prime Rate	8.25%	8.25%	7.75%	7.25%	5.25%
Gold	663.20	\$650.50	\$743.00	\$836.50	\$916.20
10-Year U.S. Treasury	4.65%	5.03%	4.59%	4.02%	3.43%
30-Year U.S. Treasury	4.85%	5.13%	4.83%	4.46%	4.31%
1-Year Certificate of Deposit	4.50%*	4.80%*	4.30%*	4.05%	2.00%*

*Past performance may not be indicative of future results. Source of Information: Issues of the Investment Book and The Wall Street Journal. \*Bank of Texas rate*

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Davidoff, Jeffrey Brown and Peter Diamond stress-tested a model that compared annuity income streams with desired consumption patterns. Their simulations found that situations in which less than two-thirds of retirement wealth should be invested in annuities were “extremely difficult.”

However, most retirees do not convert *any* retirement assets into annuities. I think there are several good reasons why, besides the wish to leave a portion of their wealth to

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*“Traditional stock/bond portfolios retain investment risk, so if the portfolio’s value drops, the investor could face smaller distributions or risk depletion.”*

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someone or some institution: loss of control due to lack of liquidity, possibility to earn higher returns through riskier equity investments, or the belief that one will die prematurely. Having an annuity income stream, however, should allow a retiree to spend more in retirement. Not only does the annuity’s longevity insurance reduce the need for precautionary savings against long life; the retiree also reaps the benefit of mortality credits. In addition, there is no other way for an individual to convert assets into a guaranteed income stream for as long as one lives.

Traditional stock/bond portfolios retain investment risk, so if the portfolio’s value drops, the investor could face smaller distributions or risk depletion. To guard against portfolio depletion and allow for the potential to increase distributions in the future

to keep up with inflation, most investment advisors recommend withdrawal rates of no more than 4 to 5 percent. On a \$1 million portfolio that would equate to a distribution of \$40,000 to \$50,000 per year, and the amount would be subject to future investment risk.

On the other hand, I received a quote from an AA+ insurer for a life annuity with a guaranteed 3 percent annual increase adjustment for a 65-year-old male that would provide an income of over \$63,000 per year in the first year, with subsequent increases at a rate of 3 percent compounded annually\*. Which of those two income streams represents the safer option for someone who wants a more stable retirement?

Needless to say, everyone’s situation is unique, and there are many factors to consider. When planning for retirement with your advisor, don’t forget this important financial tool.

*\* This illustration is as of 4/25/08 and subject to change.*

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*“Sub-Prime Mortgages”  
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paid their loans back.

**Step 4:** Pour in the Bush administration’s abandonment of its commitment to rein in government-sponsored enterprises. Instead, the administration increased lending by Fannie Mae and Freddie Mac. This moved risky loans from the financial market to the taxpayers. The financial system cannot survive if bankers make profits and the taxpayers take losses. **Step 5:** Stir in the Federal Reserve, whose easy monetary policy helped create the subsidy for mortgage and other debt, in the first place.

The government has a responsibility to prevent systemic crises and financial collapse, but not a mandate to be irresponsible. Long ago, the job of preventing financial crises was given to the Federal Reserve. It serves as the lender of last resort to the market.

Today, the Fed should not rescue individual firms, but it must keep the payments system from failing. To carry out that responsibility, the Fed has auctioned reserves and exchanged marketable Treasury bills for illiquid mortgages. So far, it has succeeded, but the problem remains unresolved.

#### **Quantification**

According to “Housing Bust Fuels Blame Game” in *The Wall Street Journal* on Feb. 27, 2008, sub-prime loans normally run at the rate of 6 to 8 percent of total loans. From 2004 through 2006, sub-prime loans ran at the rate of 18 to 20 percent of total loans. Easy money, low interest rates, poor judgment and greediness helped fuel these loans. In November 2004, the Federal government required Fannie Mae and Freddie Mac to fund more loans for low-income people, and allowed them to do so by buying sub-prime mortgages.

The percentage of sub-prime borrowers who didn’t fully document

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Conference**

**November 22,  
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their income grew from 17 percent in early 2004 to 44 percent in 2006. By the end of 2006, the foundation was laid for a crisis.

Sub-prime was initially aimed at people with weak credit. In 2005 and 2006, lenders encouraged many types of better-off borrowers to take such loans, including people with large incomes who wanted to speculate on rental housing.

To make matters worse, banks and brokerage houses leveraged mortgage collaterals to borrow more easy money at low rates to invest in other shaky ventures. When mortgage defaults started occurring, the environment also caused other investments to go into failure. This is part of the reason why it has been so hard to calculate the impact of sub-prime loan defaults. The lack of quantification of how this ripple effect will play out is continuing to cause uncertainty and volatility in the stock market.

*“In 2005 and 2006, lenders encouraged many types of better-off borrowers to take [sub-prime mortgage] loans, including people with large incomes who wanted to speculate on rental housing.”*

Getting out of these defaults, bankruptcies and non-paying notes will take time; at the end of 2007, the best estimate was six months. However, as more problems appeared in first quarter 2008, the estimated time to recover became longer and less clear. By the end of February 2008, banks and brokerage houses had written off \$150 billion in bad loans. There is undoubtedly more to come.

Barring any unanticipated collapse of a major Wall Street company, the risk of financial collapse has receded.

However, markets remain so far from normal that they are exceptionally hard to read. I believe the wave of economic pain – foreclosures, bankruptcies and layoffs – has yet to peak.

For instance, any change in the rules surrounding securitization vehicles and other off-balance-sheet entities could have widespread implications for banks. At the end of 2007, JP Morgan Chase and Citigroup had nearly \$1 trillion in assets held off their books in special securitization vehicles.

I have my thoughts on the best way to pull through (personal accountability for bad choices), but politicians will probably choose to spread the pain around among owners, investors, taxpayers and business (more regulation). The end result will be known once the economy settles down and, perhaps, when the next presidential election is decided.

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## CFM SHRED DAY A HUGE SUCCESS

On Saturday, April 19, Carter Financial Management hosted the first CFM Shred Day – and it was very successful! Clients drove through the parking garage at the Four Forest Building and dropped off documents they wanted to dispose – safely and securely. Staff was on hand with refreshments and to unload documents into the shredding bins. Those who participated felt it was a convenient and beneficial service. CFM plans to offer this service to its clients each year, so watch for Shred Day announcements in upcoming newsletters.



“President’s Letter”  
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happen in the midst of bad news.

One of the things that I have discussed many times in this letter is the importance of not letting emotions guide decisions. From the day I entered this profession, I was taught that emotional decisions nearly always lead to bad financial decisions. Now, after 35 years, I am convinced that assertion is correct. Typically, the two emotions that drive financial decisions are fear and greed. When times are good, people get overenthusiastic and tend to put too much money in high markets. When things get bad, fear seems to set in and people tend to sell when the markets are down, turning a paper loss into a real loss.

So if you feel emotions creeping into a decision, you may want to give us a call.

Perhaps the only good thing I can say about the first quarter is that it is over. There are some very positive things that are happening, and we

will discuss more of those in our next newsletter. However, I would caution that the remainder of the year will probably be somewhat difficult, even though the worst times are behind us. We will continue to monitor the situation, and, if necessary, publish a white paper between newsletters. If you have any questions, please do not hesitate to give me or your planner a call. Next time, I plan to discuss the next potential bubble.

*Bill Carter*

Bill E. Carter, CFP®, ChFC, CLU  
President

*Please note that international investing involves special risks, including currency fluctuations, differing financial accounting standards, and possible political and economic volatility. The companies engaged in the communications and technology industries are subject to fierce competition and their products and services may be subject to rapid obsolescence. Inclusion of these indexes is for illustrative purposes only. Keep in mind that individuals cannot invest directly in any index, and index performance does not include transaction costs or other fees, which will affect actual investment performance. Individual investor’s results will vary. Past performance does not guarantee future results.*

## CONGRATS!



Congratulations  
to Taylor Steele  
for attaining his  
Chartered Life  
Underwriter®  
(CLU®)  
designation!

## CFM HIGHLIGHTS

- We would like to welcome the following summer interns to CFM:
  - Lauren Branch – Baylor University
  - T.J. Gohn – University of Texas, Dallas
  - Allie Maulsby – Texas A&M University
- Congratulations to Jonathan and Autumn Meaney on their wedding!
- Jayne Grimes’ daughter, Carly, graduated from high school and has been accepted into the Honor’s Program at Tulane University!
- Brandon Ratzlaff was elected to the Educational First Steps Board of Directors!
- Bill Carter and Kathy Muldoon attended the Raymond James Chairman’s Council Meeting in Chicago, April 15-18.
- Bill Carter was the featured guest speaker at the Emerald Coast A&M Club’s 2008 Muster in Ft. Walton Beach, Fla, April 21.
- Bill Carter attended a Baylor Oral Health Foundation Board meeting in Dallas, March 29 and May 16; a Private Enterprise Research Center Board meeting and the Texas A&M Legacy Society Celebration in College Station, April 2-3; and a Capstone meeting in Kansas City, April 4-6.
- Carter Financial Management’s held its semi-annual Charity Day June 3 at the Heritage Farmstead Museum (see page 7 for a summary and photos).
- Bill Carter, Bob Berg, Kathy Muldoon, Leona Martin, Tara Scottino and Tom McIntire will attend a Management Team Meeting in Santa Fe, June 11-13.
- Bill Carter will attend a Senior Source Board meeting in Dallas, June 24; the Morningstar Investment Conference in Chicago, June 25-27; and the Raymond James Regional Conference in Asheville, NC, July 15-18. ■

## CHARITY DAY

### CFM MAKES “CLEAN SWEEP” AT HERITAGE FARMSTEAD

**I**t was back to basics during Carter Financial Management’s latest Charity Day on Tuesday, June 3 at the Heritage Farmstead in Plano.

Built more than 115 years ago as a working farm, Heritage Farmstead now operates as a museum to preserve a by-gone way of life. In fact, the Farmstead’s Association works to preserve, teach, and demonstrate the past to more than 30,000 visitors annually.

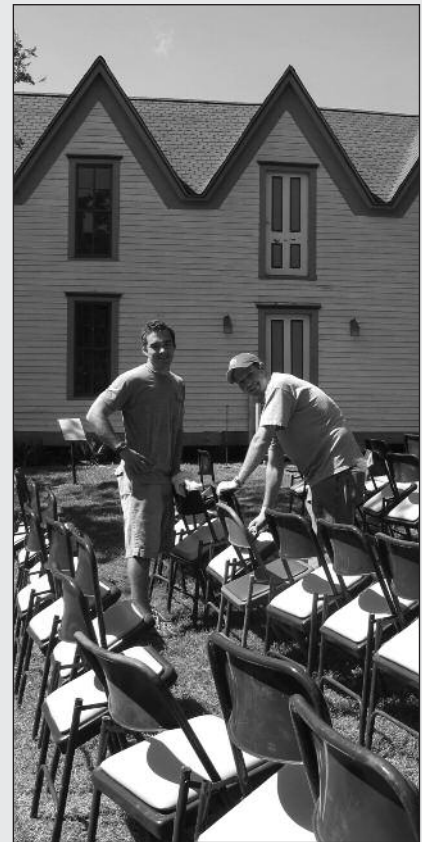
In the bright sun on an early June day, CFM’s employees were seen:

- sweeping the Pole Barn, Young House, One Room

Schoolhouse, porches and walkways;

- weeding the kitchen and flower gardens;
- washing event chairs;
- sorting wool used for children’s educational events;
- picking up trash and branches from around the four-acre grounds and along Pitman Creek on the west side of the property;
- cleaning out and dusting some of the outbuildings; and
- raking and weeding around the historic farm equipment.

For more information on Heritage Farmstead, visit [www.heritagefarmstead.com](http://www.heritagefarmstead.com). ■



▲ Chris Moreland (left) and Taylor Steele wash chairs



◀ (from left) Allie Maultsby, Patty Hammond and Kathy Muldoon sort wool.



# CARTER FINANCIAL MANAGEMENT

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## CFM MISSION STATEMENT:

Our mission is to become our client's trusted advisor by providing superior financial planning services that enable our clients to define and achieve their financial and life goals.

## RJFS DEADLINES

### Cutoffs:

Trades/Mutual Funds.....3:00 CST  
No Load Mutual Funds – Buys: .....1:00 CST  
No Load Mutual Funds – Sells:.....2:30 CST  
Nuveen Munis .....10:00 CST  
Government Bonds .....4:00 CST  
Wires-From Customer Accts. ....12:30 CST

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