The Compass™

Appleton Group Wealth Management, LLC
100 W. Lawrence Street, Third Floor
Appleton, WI 54911

THE APPLETON GROUP
10 Years
2000-2010
WEALTH MANAGEMENT DISCIPLINE

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Appleton Group Wealth Management LLC is an independent, Registered Investment Advisor (RIA) located in Downtown Appleton, Wisconsin. We provide wealth management services for investors, using time-tested asset management strategies that prepare for cooperative and uncooperative markets. Since our founding in 2002, our firm has been recognized both locally and nationally as a leader in the wealth management community.

Appleton Group Wealth Management, LLC currently manages $134.423 million, serving advisors, individuals, families, trusts, corporations, institutions, endowments, foundations, and company sponsored retirement plans.

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One Decade in the Books:
The Appleton Group Wealth Management Discipline™ Celebrates Its Ten-Year Anniversary

As the old saying goes, "necessity is the mother of invention." Back in the summer of 1998, it became apparent that investors needed something that I had never heard of before, something that would become so important to the financial lives of Americans that if it didn't already exist I knew right away I'd have to invent it. In the summer of 1998, a frighteningly quick bear market was upon us and I knew right away that it was an experience I didn't like at all. Neither did my clients.

How did it get started? Like so many market downturns it had as much to do with the successful market advance that had occurred during the preceding few years as it did with any single triggering event itself. The markets had been humming along nicely, up over 20% each year from 1995 through 1997 – by all definitions a raging bull market. But the bear market of 1998 was caused largely by the collapse of a major hedge fund out East, *Long Term Capital Management* which at the time was big enough to take down the global economy and several international currencies as well. The Russian ruble crumbled, as did the Indonesian rupiah and the Brazilian reál. In a matter of eleven weeks, the S&P 500 lost more than 22% of its value.

Mark C. Scheffler
Senior Portfolio Manager,
Founder

Scary stuff then, just as it is today. I remember a number of my clients sharing their fears with me, but I knew that their fates were largely in the hands of the market itself. As much as I wanted to intervene, the brokerage system that I was immersed in at the time just wasn't set up to enable that to happen. As it turned out, the Federal Reserve and other central banks slashed interest rates and the market recouped all of its losses by Thanksgiving of that same year. Disaster averted (for a time), but it served as a real wake-up call that investors needed

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The Next Ten Years: Moving from Good to Great

With ten years of concrete, objective data now in the books, The Appleton Group Wealth Management Discipline™ is unquestionably a winning strategy. From ten-year net performance to effective risk management to a high degree of predictability, it's simply a better way to invest.

Over the past ten years, the markets have been flat-out, well, flat. It wasn't for a lack of volatility, mind you – the last decade has certainly seen its share of ups and downs in so many markets. But on balance, those who advocate a "buy and hold" approach to investment management have fallen woefully short. From our experience in financial planning, we know that most investors need to achieve an average annual return of somewhere between 7% and 9% to make their financial engine run smoothly. With this range squarely in mind, the ten-year performance of many of our firm's offerings, while solid, has fallen just a bit short of this goal.

The article I wrote above is meant to look back at the past ten years. In contrast, this article is meant to look forward, identifying opportunities and adjustments that are intended to make the next ten years of service even more beneficial to our investors.

Adding an Extra Gear

While road biking through the hills above Oakland, California last summer with my cousin, I found myself making full use of the 21 gears that I had at my disposal. Smaller gears for climbing – gears designed to make it easier to propel both me and my bike to the top of some really impressive hills, and larger gears for our descent – gears designed

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The Next Ten Years: Moving from Good to Great... concluded

to create impressive speed with little effort. It dawned on me that our investment model could benefit from the same kind of engineering.

For much of the last ten years, our investment management model treated rising markets and falling markets exactly the same – adjustments were made in response to changing market conditions using the same time span (typically 4-6 weeks). But we know that falling markets have become much more volatile and choppy than rising markets. This was certainly true in 2008 and early 2009, just as it was in the bear market of 2000 – 2002. The five-year bull market in between was completely different, running its course without as much as a 10% correction.

Because of this fact, it is apparent that a falling market requires a more rapid response (which we've certainly excelled at) than a rising market does (which we've not been as good at). Since mid-summer, we've implemented an adjustment to our model that uses a smaller gear during periods of sustained market declines and a larger gear for sustained market advances. It adjusts more rapidly during falling markets but reduces our activity during rising markets. Our many months of research have proven very beneficial in this area, and has markedly increased the amount of participation in a rising market without demonstrating an increase in our overall level of risk. This is a significant step forward.

Not All Investments Are Created Equal

Any well diversified portfolio (as all of ours certainly are) uses a wide variety of assets that are intended to complement one another, some "zigging" while others are "zagging." We know that real estate often acts differently than U.S. equities, which respond differently than commodities, which act differently than fixed income assets. Because of this fact, each investment vehicle we use would benefit from a slightly different set of time frames off of which to make meaningful and well-timed adjustments.

These time frames are known as Simple Moving Averages (SMAs), which I've written about extensively in my book, *On The Right Side of the Market*. For each security we use, we've implemented a process I call "Simple Moving Average Optimization." Quite a mouthful (as you might expect from me), but it's a straightforward way to "unlock" the best combination of timeframes from which to make the most meaningful and potentially profitable investment decisions for a particular security. It works to create the most efficient combination of best returns, lowest risk, along with the fewest number of adjustments (which helps to keep investment expenses low).

Separating Risk-Managed Investments from No-Risk Investments

I'm more convinced than ever that every American (and probably every one else in the world, for that matter) could benefit tremendously from risk managed portfolios like ours. If free market capitalism is going to continue to be the dominant economic model – and I see no real chance of that fact changing – the next decade will require flexibility. That being said, for retirees and community foundations and college endowments and other investors who are actively withdrawing assets from their investment portfolios (or soon will be), **it is critically important to set aside two to three years of ultra-low or no-risk assets to allow for the normal ebb and flow of the rest of your portfolio.** While this is more of a portfolio structure issue, I can't stress enough the importance of securing a multi-year income stream from market risk, even if it is being professionally managed. From an emotional standpoint, I've come to the conclusion that investing is a sometimes terrifically difficult endeavor. It requires an incredible amount of focus, clarity and emotional balance from both investor and advisor. Having several years of no-risk assets (not too much, mind you) can help to steel an investor from the normal hype that our media-driven culture produces.

I believe that our discipline is already better than 90% of the other investment strategies available to investors – our ten-year rankings (due out next month) may very well bear that out. But I'm also convinced that we too need to continue to evolve, taking a process that has been really good to one that is really great. And I look forward to what the next ten years will bring. It will almost certainly be a period of great change, great opportunity, and great reward for those who can best take advantage of the dynamic system known as the free markets!

-MCS

Ten Things I Think I Know…

1. Markets don't always cooperate with our schedule.
2. Investing is as much an emotional endeavor as a cerebral one.
3. In investing, price is everything.
4. In price, timing is everything.
5. Opportunity is not a lengthy visitor.
6. There's only one benchmark that matters: the return necessary to make your own financial plan run smoothly.
7. 99% of daily financial data is mere noise.
8. The wisdom of the investing crowd is far more powerful than the insight of an individual participant.
9. Investing should be FUN!
10. See #9.

Ten Questions for the Next Decade…

1. Will free market capitalism still be the dominant global economic model in 2020?
2. Is there an environmental limit to human development and growth?
3. Will every house have 3-D projection TV?
4. How many American lifestyles can our planet support?
5. Will our political process allow for the presence of a viable third party?
6. Will the term "global warming" be retired, to be succeeded by "global climate change?"
7. Will the world economy be larger or smaller than it is today?
8. Will the Milwaukee Brewers ever get back to the World Series?
9. Will consumer culture be replaced by a more sustainable model?
10. Will the Amish have the last laugh?

Stay tuned for the answers… *-MCS*

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something better.

In short order, I began a quest to look back at what kind of market research and investment structure had offered clients the best combination of growth and risk management. It seemed that none of the traditional growth mutual funds that were available at the time did anything more than expose investors to the full brunt of the market downturn. It was a "no pain, no gain" mentality (that I believe still is pervasive today). On top of it, the market research that Wall Street and regional brokerage firms paid millions of dollars to produce either didn't see the downturn coming, flat out got it wrong, or just pooh-poohed the disintegration of one-fifth of the equity ever created by humanity as an unavoidable event. "You can't time the market" was a mantra used again and again to pacify investors.

To me, the bear market of 1998 was a seminal event, a Godsend, a moment of clarity. It sent me on a two year quest to develop an answer to the question "What do we do if the market becomes uncooperative?"

By late 1999, I discovered the potential power of combining exchange traded funds (ETFs) – *what to own* – with a statistical research model – *when to own*. To the best of my knowledge there were only a small handful of people in the investment business who had come to the same conclusion as I did. The idea was solid, but there was no experience to validate my beliefs. There was no evidence to back it up. It had simply never been done before.

So in year 2000 I began a ten-year quest to document every facet of my idea: every buy, every sell, every dividend, every interest payment, every expense. To assess whether there was good value I would have to be able to calculate and publish specific data points, including net performance, the amount of risk incurred, predictability of returns, the value added by the management process, as well as the out-of-pocket costs that would need to be assessed along the way. As the body of statistics became larger with time, investors began to see the significant value in addressing the question of what to own and when to own it.

Almost immediately the evidence indicated that I was on to something. The portfolios started with only three ETFs, two of which were paired up with bear market mutual funds that gave the portfolios a significant amount of protection and profit during the early going of the last bear market (2000-2003). After only a short time, it became apparent that the markets were ready to fly apart at the seams, and the dot-com blowup soon was in full swing. In life, timing really is everything. As it turned out, year 2000 was the start of a really tough slog for the markets.

What became painfully apparent was that it would be impossible to effectively deliver the value of this new discipline in my current role as a broker. Brokers are salespeople, not money managers, and the difference is as clear as night and day. Every time my statistical model prescribed a new buy or a sell I would have to place a call to every one of my clients who was following the model, explain that I was recommending a change, and get their permission to make that change in their account. A small number of my brokerage clients had already made the decision to follow the discipline, but every time there was a change they'd have to make another decision to actually implement it. This simply wouldn't work.

After making it through the dot-com blowup, and then through 9/11 I knew that I'd need to make a decision: Was I going to continue to be a broker, or was I going to become a full-time investment manager? The answer to that question was easy to find, and in early 2002 I left the brokerage world forever with no clients, no assets to manage, a five month-old son, and one heck of a good start to my discipline. I started Appleton Group Wealth Management LLC in April of 2002, and the rest as they say is history.

Ten years have now passed since I took the first steps to establish what we now call *The Appleton Group Wealth Management Discipline*™. With a complete decade now in the books (and the world looking a whole lot different than it did ten years ago, I think it's a great time to dig into the numbers to see how we stack up.

Three core portfolios.

There are three core portfolios we offer that each present a slightly different structure for the discipline. The Appleton Group PLUS Strategy represents our most flexible offering, with the ability to be as much as 97% invested in at-risk assets, as much as 100% cash, and up to 45% invested in bear market securities (which profit when the markets go down). The Appleton Group Tax Managed Growth Strategy is similar in that it can be up to 97% invested in at-risk assets and up to 45% invested in bear market securities, but we limit the amount of cash to a maximum of approximately 50%. Lastly, The Appleton Group Portfolio can be up to 97% invested in at-risk assets, up to 100% cash but with no bear market securities allowed at any time.

Three variations, each highly adjustable in response to changing market conditions.

So after a decade, here's how we stack up:

Ten years of solidly positive returns.

Performance is relatively easy to measure, and represents the average annual return for the investment after all fees and expenses have been deducted.

The Appleton Group PLUS strategy is the winner here. Over the past decade it has averaged +6.45% per year. A close second is the Appleton Group Tax Managed Growth strategy: +6.07% per year, and The Appleton Group Portfolio strategy with a +4.97% average annual return. By comparison, the S&P 500 Total Return Index has lost an average of -0.95% per year.

Each strategy successfully met the goal of producing net positive returns despite the presence of an uncooperative overall market environment.

Ten years of significantly reduced risk.

The industry standard for measuring risk is through a measure called "beta." Beta compares the risk experienced by an investment to a standard benchmark, such as the S&P 500. The higher the beta, the higher the historic risk has been. By definition, the S&P 500 carries a beta of 100%. Anything below this number is considered a lower risk investment.

Just as in the performance statistics above, the Appleton Group PLUS strategy flat-out

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excelled during the decade, experiencing only 16% of the risk of the S&P 500 TR Index. The Appleton Group Tax Managed Growth strategy finished with a beta of only 33% and the Appleton Group Portfolio strategy rounded out the field with a beta of only 44%.

In all, the strategies each achieved the goal exposing investors to significantly less market risk during a high risk market environment.

Ten years of increased predictability.

Our industry places a lot of value on the predictability of a particular investment's returns, using a measure called standard deviation. However, many in our field mistake standard deviation as a measure of risk – it is not. The higher the standard deviation, the less predictable the returns.

Over the past decade, the S&P 500 produced a standard deviation of 21.11%. For the non statistician this is off the charts, and is a result of wild swings in annual performance. Each of the Appleton Group Wealth Management strategies offered greater predictability: The Appleton Group Portfolio strategy was the most predictable at only 12.41%, next came the Appleton Group PLUS strategy at 13.09% and the Appleton Group Tax Managed Growth strategy with a standard deviation of 13.22%.

Each of our strategies offered significantly more predictability when compared to the basic market itself - no small feat.

Ten years of having little dependence on the markets.

For the overwhelming majority of investors, the markets themselves are the sole determining factor when it comes to their own investment outcomes. As go the markets, so go their portfolios. Over short periods of time (three years or less), investors may get whipsawed, experiencing their share of double digit gains, but many also participate in losses that may often exceed 20% or more in any year. But over longer periods of time markets can remain flat or even decline, exactly as we saw over the last decade. The S&P 500 TR index fell by a cumulative 9.12% over the decade (with all dividends reinvested along the way). For any investor to successfully achieve the returns they need to make their financial engine run, it is becoming increasingly important to have little or no dependence on the markets.

This too is measurable, using a statistic known as "r-squared." The big picture is this: r-squared measures the percentage of a particular investment's returns that are a result of the markets themselves. For example, an index fund that is designed to track the S&P 500 would have an r-squared of nearly 100% - ALL of its returns are a result of the market, both good and bad.

For the last ten years, the dependence on the markets for returns has been significantly lower for all of our managed strategies. Again, our PLUS strategy came out on top, with less than 4% of its returns being attributable to the markets. Our Tax Managed Growth strategy was second with an r-squared of only 33% and the Appleton Group Portfolio Strategy demonstrating just a bit more dependence on the markets at 48%.

It can be concluded that each of our managed portfolios successfully limited their dependence on the markets.

Ten years of adding value.

There are really only two outcomes when a professional manager implements an active investment strategy: they either add value (by outperforming) or simply get in the way (leading to underperformance). This too is measurable and is described as alpha. Passive investments, by definition, have little or no alpha – they don't try to. They simply get whatever returns their particular benchmark happens to produce with little outperformance or under performance.

Over time, Alpha can be a good gauge to determine whether a particular strategy (like ours) really does help. It measures the excess return a particular strategy has produced compared to a particular benchmark. While it cannot predict future performance, the longer the period of time being measured the more accurate it becomes as a forecasting tool. The higher the alpha, the more value has been added.

Over the past decade, each of our managed portfolios produced significant alpha compared to the overall markets, as measured by the S&P 500 TR index. The PLUS led again, with an alpha of 7.36%. Tax Managed Growth was a close second at 6.79% and the Appleton Group Portfolio added an alpha of 5.34%.

All winners here as well.

Ten years of sustainable investing.

There is one metric, however, which is immeasurable: whether a particular strategy can be used to help sustain an investor's portfolio in perpetuity. All in all, one aspect of the discipline that I have been most pleased with is that over the last decade we've helped investors to stay ahead of the game. What's the game? It's remaining solvent, producing a sustainable income stream that an investor won't outlive, and implementing a discipline to pass current wealth on to future generations. The Appleton Group Wealth Management Discipline™ has helped investors dodge a whole lot of bullets over the past decade. While not perfect, the discipline has been really good. Time will tell if the next decade produces a more cooperative environment, one in which investor returns become more normalized. But regardless of the overall environment, it remains our goal to produce returns over time that help investors keep their current lifestyle intact forever.

-MCS

1. Performance quoted represents past performance and is no guarantee of future results.
2. Performance information provided indicates what effect the portfolio adjustments generated by the Appleton Group Wealth Management Discipline™, strictly implemented, have had on a model portfolio as such portfolio adjustments were implemented. Although the portfolio adjustments are actual recommendations which have been generated by the Appleton Group Wealth Management Discipline™ since December 31, 1999, the performance results are for a model portfolio and do not represent the actual performance of accounts managed using the Appleton Group Wealth Management Discipline™.
3. Performance statistics for years 2000-2005 have been calculated net of management fees, net of applicable expenses and net of brokerage costs using a time weighted calculation method. Unlike an actual performance record, these performance results do not reflect the impact a client's economic circumstances might have had on Appleton Group Wealth Management's decision making when managing a client's actual portfolio. Investors should not consider the performance data a substitute for the performance of actual client accounts. Performance information reflects weighted historic performance, rebalanced monthly.
4. Performance statistics for years 2006-present represents actual client performance calculated using the Global Investment Performance Standards (GIPS). Our firm does not claim GIPS compliance for our entire performance history due to the linking of model portfolio performance (2000-2005) with actual client performance (2006-present). Performance statistics for both periods have been independently verified by a certified public accounting firm whose validation letters and a complete history of our performance are available upon request (and can be viewed at www.appletongrouponline.com).
5. While performance is compared to the benchmark indicated, client accounts may be fully invested, partially invested in cash equivalents, invested in inverse ("bear market") funds and/or "short" the market, depending on the portfolio selected. The actual amount of time invested in the market will vary with market conditions.
6. The principal value and return of exchange traded funds and other mutual funds will fluctuate with changing market conditions, and may be worth more or less than your initial investment. All dividend, interest, and capital gain distributions assume reinvestment. Performance statistics do not consider potential tax liabilities as a result of management activity. Please consult your tax advisor for further information.
7. Prior to being branded as *The Appleton Group Portfolios*™ these portfolios were marketed as *The Compass Portfolios*. Appleton Group Wealth Management, LLC became the investment advisor for *The Appleton Group Portfolios*™ on April 5, 2002. Prior to that date, Mark C. Scheffler solely managed *The Compass Portfolios* on a non-discretionary basis while employed as a broker with Robert W. Baird & Company, Inc. which enables the prior firm performance to be carried forward to Appleton Group Wealth Management LLC.
8. Deviation from the models has produced and will produce substantially different results. The S&P 500 TR Index is a broad based unmanaged index of 500 stocks, which is widely recognized as representative of the U.S. equity market in general. You cannot invest directly in an index.