The Compass™

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The Appleton Group, LLC was founded to fulfill an investor's desire to participate in the U.S. equity markets while simultaneously addressing the need to manage investment risk. Our firm was founded in April of 2002 by Mark C. Scheffler who serves as Senior Portfolio Manager.

The Appleton Group, LLC currently serves 48 clients, and manages $31.5 million of investable assets. We serve individuals, families, corporations, institutions, endowments, trusts and company sponsored retirement plans.

The Appleton Group, LLC is a Registered Investment Advisor, regulated by the United States Securities and Exchange Commission.

Inside this issue:

The Wisdom of Crowds

In May of 1968, the US Submarine *Scorpion* disappeared on its way back to Newport News after a tour of duty in the North Atlantic. Although the Navy knew its last reported location, it had only the vaguest sense of where it may have traveled before being lost. As a result, the area where the Navy began searching for the *Scorpion* was a circle twenty miles wide and many thousands of feet deep. Needless to say, a recovery effort could only be attempted after the sub was found.

The solution? Track down three or four top experts on submarines and ocean currents, get them to work together, ask them where the *Scorpion* was, and search there. But an officer named John Craven had a different plan.

Instead of asking the experts to consult with each other, he put together a list of his own experts, including mathematicians and salvage men, each specializing in widely different areas. He then asked each of them to work independently and offer their best guess on their own. And so Craven's men got started.

Working independently, they each came up with their own informed guess as to where the sub was. Craven believed that each of them was likely to be wrong; but he also believed that if he took each result and combined them, it may yield a better result than even the best guess. When they were finished, he had in hand the group's collective guess as to where the sub was.

The location of the group's collective guess was not a spot that any individual member of the group had picked. The final estimate was in reality the collective judgment that the group as a whole had made, and it was collectively brilliant: after only five months of searching, the *Scorpion* was found, just 220 yards from where Craven's group said it would be.

This true account is one of numerous examples in "The Wisdom of Crowds," a newly released book by James Surowiecki, a frequent contributor to *The New Yorker*, and a freelance

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author. Surowiecki's book is based on the idea that a group made up of interested but independent individuals is better able to devise solutions to complex problems than any one individual or a small group of "experts." The book cites numerous examples as varied as hunting for lost submarines to guessing the number of jellybeans in a jar. The author

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Handicapping the Presidential Race

For many, the only poll that matters in the upcoming Presidential election is the final one: the election itself. If the point were ever to be made that every vote counts, the upcoming election should make the case quite convincingly. According to Time Magazine, no fewer than 20 states are still considered battleground states, and recent polling suggests a statistical dead heat. Let's place a bit of a wager, shall we?

One method of polling that gets my vote for accuracy and predictability are the Iowa Electronic Markets. This inventive polling system doesn't take place just once, but throughout the day much in the same way the markets themselves can act as a poll (see "The Wisdom of Crowds" above). Participants buy futures contracts on a possible election outcome, in

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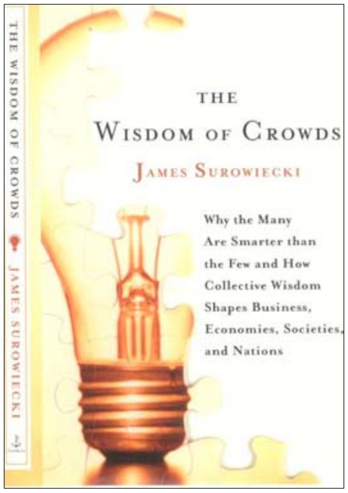
The Wisdom of Crowds (continued from page 1)



details the three types of problems that a crowd of interested individuals might be able to collectively solve (or at least produce a useful answer).

There are three basic types of problems that crowds (like market participants) can be asked to solve. First there are "cognition" problems. These are problems that have definitive answers. "Who will win the Super Bowl this year?" Only one answer will be right, and only time will tell. Next come "cooperation" problems. Paying taxes, dealing with pollution, political compromise all deal with getting self-interested, distrustful people to work together to solve common problems. Lastly (and most important to us) are "coordination" problems. These problems require members of a group to coordinate their behavior with each other. The market is a great example of a coordination problem.

Of interest to all investors is putting the collective judgment of the market to work either to provide a predictable marketplace, to enhance returns or to manage investment risk. In this case, all market participants let their actions (buying and selling) not only determine prices but also help us to define the current market environment. Read on...

The Inner Game of the Markets

Warren Buffet, the chairman of Berkshire Hathaway and renowned investor has said "In the short term, the markets are a voting machine." Every day on the New York Stock Exchange, billions of shares trade hands, and every share can be thought of as a vote either for or against a particular company. Large blocks of stock get a greater voice than smaller trades, which in turn can move the markets either up or down. A disproportionate number of buys can propel the markets higher, a disproportionate number of sells can push the markets lower. In a manner of speaking, the markets not only set stock prices but can also be used to gather information about the market environment based on trading activity.

Every trade can be recorded, measured, dissected and interpreted. For our purposes, we collect trade data every day and use it to answer the all important question: "Should we be invested?" After all, if the collective wisdom of the crowd is clearly bullish, it makes sense to correctly identify what the crowd is telling us, and then take appropriate action. Likewise, if the crowd is clearly bearish, a very different course of action is warranted.

Experts

Years from now, if anyone remembers anything about the hit TV show "Who Wants to Be a Millionaire?", it should be a contestant's brief phone call to a friend, hoping that s/he will help them by providing the right answer. The contestant is relying on the advice of someone whom they think is an expert in a certain field. What people probably won't remember is that the show pitted individual intelligence against the

> *"Truly successful decision making...demands more than just a picture of the world as it is. It demands in addition a picture of the world as it will (or at least as it may) be."*

group's collective intelligence when the contestant chose to "poll the audience." The audience would immediately place their votes by computer, and seconds later the results would be displayed. Which method of help worked best?

According to Surowiecki, the phone-a-friend lifeline worked pretty well, with the expert offering the right answer 65% of the time. Not bad. But the audience (a randomly assembled crowd comprised mainly of tourists) got it right 91% of the time. Much better, and much more beneficial. Remember the small group of highly touted market analysts in the late 90's who optimistically predicted that the Dow would reach 30,000? Remember the same group who recited the mantra "the stock

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Flatter than a Pancake?

To commemorate the current flat market, we thought it would be appropriate to note several other topographical oddities:

-As it turns out, Kansas really is flatter than a pancake. According to the website "Annals of Improbable Research (AIR), a typical pancake from IHOP comes in at 0.957 (1.000 is perfectly flat) while the state of Kansas comes in at an impressive .9997 degree of flatness.

-"The Flat Earth Society" is an organization dedicated to debunking the round earth theory supported by many "so called scientists." Their activities also include "The Flat Earth Liberation Front Against Television" which aims to fight the "evil that has spoiled this once great world," otherwise known as daytime TV.

-The University of Alaska at Fairbanks publishes a pamphlet called "Flat Out Facts About Halibut." This fish lies flat on the bottom of the ocean , but both of its eyes are found on one side. As if the profile of the fish isn't hard enough to get used to, UA-Fairbanks pamphlet can tell you how to tell a right "handed" fish from a lefty, the largest fish was as big as a barn door, and it includes some favorite recipes. Bon Appetit!

From the desk of Mark C. Scheffler:

The Patient Market...

In this edition of *The Compass* we've hit on two topics that at first glance seem to have nothing in common: the influence that large, independent crowds can have on society, and the difficulty of dealing with flat markets. I can't speak for everyone, as your experience may be quite different than mine, but I believe that both forces present emotional challenges that can often be difficult to come to grips with.

I believe that most investors are people of action. We are "doers," people who like to take matters into our own hands, people who find it difficult to sit back and let life just happen. Speaking generally, many of us have caught the entrepreneurial spirit that has made America "the land of opportunity."

For many, this spirit has been a part of our family bloodline. After all, my great grandfather (perhaps like your ancestors) left his homeland at great peril to arrive in America, facing great uncertainty but also great opportunity. Survival wasn't just enough for the family. Progress, improvement, luxury resulting from hard work, all a part of our family lines. Arrive first, thrive next.

By definition, flat markets imply a difficult lack of progress. While not unusual, they are neither interesting nor rewarding. The path from start to finish may be very narrow (as it has been for much of this year), or the journey can very much resemble mountains and valleys (as it has since 1998). Mountains and valleys can be very useful, as we are generally able to harvest substantial gains while minimizing substantial losses. But the flat market of this year has simply not provided enough volatility to make a real difference (either positive or negative).

Stagnation naturally invites the question: "What else can we be doing", and in most years there are pockets of growth that at least present minor opportunities, but few have presented themselves this year. Truly, a test of patience.

In a very real way, the crowd discussed in our cover story is prescribing the current flat market. Insofar as the markets reflect all of the known data at the current time, the buying and selling of the crowd essentially determines whether the market is undervalued, overvalued or fairly valued. The flat market of 2004 indicates the latter, neither overvalued nor undervalued. As my two year old son knows so well from Goldilocks, the market is "just right." But just right doesn't help. If the market got it just right every time, there would be little movement, and thus no progress. So too does it test our patience.

But if there is one truism in all fairy tales, they eventually come to a tidy end, and a new story begins. A new chapter will unfold in due course, as it always does, the only uncertainty being when. John Quincy Adams wrote, "Patience and perseverance have a magical effect before which difficulties disappear and obstacles vanish." In due course, the tide will undoubtedly change, and we remain ever committed to being positioned properly when it does. In the meantime, live richly, breath deeply, and look ever forward!

The Wisdom of Crowds (concluded from page 2)

market only goes one direction over time" when the S&P 500 had declined nearly 40% from it's peak? What gives?

The answer involves the same randomness that the group of tourists visiting the game show had experienced. Market experts violated the two primary conditions that Surowiecki says are required to make the crowd work: Diversity and Independence.

The Useful Crowd

Surowiecki maintains that for any crowd to be a good problem solver, the individuals who make up the crowd must be both diverse and independent of one another. Diversity is important because the individuals who are asked to cast their collective votes rely on a varied personal background and experience from which to form their judgment. In the case of the market, votes are cast not only by professional money managers but also by regular folks who may or may not have "expert credentials." This lack of expertise actually seems to offset the overconfidence that professional money managers can demonstrate.

Independence is critical for two reasons: First, it keep the mistakes that people make from becoming correlated. In other words, a mistake made by one member of the crowd isn't likely to show up across the board and thus skew the results. Second, independent individuals "are more likely to have new information rather than the same old data everyone is already familiar with. The smartest groups, then, are made up of people with diverse perspectives who are able to stay independent of each other."

This is exactly what the market experience has been. Every day, billions of votes are cast by a diverse pool of investors who (Martha Stewart aside) act independently of one another. Objective wealth managers, such as The Appleton Group LLC, harvest valuable information based on this activity, and use it to assess the health of the markets. A healthy environment is one in which buyers systematically outnumber sellers. A healthy market environment is one in which cash is invested rather that saved. A healthy environment is one in which the crowd coordinates its activity to drive prices higher.

In a manner of speaking, the market is the ultimate democratic bullhorn. Everyone who participates gets a voice. All voices are relatively equal (although some are louder than others!). All participants are able to make informed judgments and are able to share equally in the opportunities of the markets (if not equally in the outcome). Most importantly, the markets enable us to democratically place our future decision making in our own hands. "Truly successful decision making...demands more than just a picture of the world as it is. It demands in addition a picture of the world as it will (or at least as it may) be."

-MCS

The Compass Portfolios: Historic Performance Summary*

Compass Portfolio Component	*Morningstar Category*	*Q3 2004 Total Return*	*2003 Total Return*	*2002 Total Return*	*2001 Total Return*	*2000 Total Return*
Compass Classic PLUS—NASDAQ 100	Lg. Cap Growth	-3.76%	+41.29%	-2.85%	+49.89%	+18.11%
Compass Classic—NASDAQ 100	Lg. Cap Growth	-5.64%	+42.07%	-12.47%	+8.27%	-7.41%
	Vs. NASDAQ 100 Index	**-6.85%**	**+49.12%**	**-37.58%**	**-32.65%**	**-36.84%**
Compass Classic PLUS—S&P 500	Lg. Cap Blend	-4.19%	+19.73%	-12.86%	+25.77%	-8.12%
Compass Classic—S&P 500 Index	Lg. Cap Blend	-2.88%	+23.62%	-14.31%	+4.02%	-8.88%
	Vs. S&P 500 Index	**-2.30%**	**+26.38%**	**-23.37%**	**-13.04%**	**-10.42%**
Compass Classic—Dow Jones Ind. Avg.	Lg. Cap Value	-4.42%	+24.93%	-12.26%	+2.24%	-6.01%
	Vs. Dow Jones Industrial Average	**-3.40%**	**+25.32%**	**-16.76%**	**-7.10%**	**-6.17%**
Compass Classic—Russell 2000 Sm. Cap Gr.	Sm. Cap Growth	-4.45%	+44.52%	-14.97%	NA	NA
	Vs. Russell 2000 Sm. Cap. Gr. Index	**-6.01%**	**+47.56%**	**-30.70%**	**NA**	**NA**
Compass Classic—Russell 2000 Sm. Cap Value	Sm. Cap Value	-5.34%	+46.00%	+2.07%	NA	NA
	Vs. Russell 2000 Sm. Cap Value Index	**+0.15%**	**+43.27%**	**-13.21%**	**NA**	**NA**
Compass Classic—Managed Income Portfolio	Domestic Hybrid	+5.36%	+16.76%	+14.96%	NA	NA
	Vs. Balanced Benchmark	**-0.51%**	**+17.42%**	**-10.72%**	**NA**	**NA**

*Important information: The Compass Portfolio performance information provided indicates what effect the buy and sell signals generated by the Compass Wealth Management Discipline have had on a model portfolio comprised of the index shares (iShares) indicated if such buy and sell signals were implemented. Although the buy and sell signals are actual recommendations which have been generated by the Compass Portfolio 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 Compass Portfolio Management Discipline. Performance statistics have been calculated net of a 1.00% management fee, net of applicable mutual fund expenses and net of brokerage costs using the internal iterative rate of return (dollar weighted) calculation method. While performance is compared to the benchmark indicated, client accounts may be fully invested, partially invested in cash equivalents, or invested in inverse ("bear market") funds, depending on the portfolio selected. The actual amount of time invested in the market will vary with economic conditions. Unlike an actual performance record, these performance results do not reflect the impact a client's economic circumstances might have had on the investment adviser's decision making if the investment adviser were managing a client's money. Investors should not consider the performance data a substitute for the performance of actual client accounts, nor should investors consider this data as an indication of future performance. The principal value and return of common stocks and equity 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 into the targeted investment. Performance statistics do not consider potential tax liabilities as a result of management activity. Please consult your tax advisor for further information. The Appleton Group, LLC became the investment advisor for The Compass Portfolios on April 5, 2002, with Mark C. Scheffler serving as the sole portfolio manager. Prior to that date, Mr. Scheffler managed The Compass Portfolios on a non-discretionary basis while employed as a broker with Robert W. Baird & Company, Inc. A complete history of all portfolio recommendations is available upon request. The unmanaged index for the Compass Classic—Managed Income Portfolio is a composite of the S&P 500 Index (60%) and the Vanguard Total Bond Market Index Fund (40%). Deviation from the models will produce substantially different results. The Appleton Group LLC is regulated by the U.S. Securities and Exchange Commission and by the State of Wisconsin, Department of Financial Institutions.

Handicapping the Presidential Race (continued from page 1)

this case either a Bush or a Kerry victory. The winning contract takes all, in this case $100. The cost of the contract is determined by the market for the contracts. Excessive buying of one contract pushes the price up while simultaneously pushing the opponent's contract down in price. At any given time, the two contracts together equal the winning purse, $100. If you bought a Bush contract today and he won on November 2, your payout would be $100, holders of the Kerry contract get nothing. Simple enough!

What are the contracts currently saying? As of Midnight, October 8th the IEM Winner-Take-All Presidential contract had President Bush in the lead 54% to Kerry's 46%. So, how accurate are the Iowa Electronic Markets?

According to James Surowiecki's *The Wisdom of Crowds*, the results are pretty good (that is to say, accurate). A study of the IEM's performance in forty-nine different elections between 1988 and 2000 found that the election-eve prices in the IEM were, on average, off by just 1.37 percent in presidential elections. That means that if the election were to be held today, Bush should get somewhere between 52.63% and 55% of the vote. Either of these two outcomes predicts a squeaker for the incumbent.

You can view the IEM data (updated daily) online at http://www.biz.uiowa.edu/iem.

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