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PLANNER PROFILE

CHALLENGING COMMON ASSUMPTIONS AND EMPHASIZING FLEXIBILITY HAVE BEEN KEYS TO MARK SCHEFFLER'S SUCCESS AS AN ADVISOR

Investment Composer

BY ROBERT F. KEANE

THE TYPICAL BACKGROUND FOR A FINANCIAL advisor is a business degree followed by an entry-level job with a wirehouse or large accounting firm. Or, maybe it's college and then law school. Mark Scheffler heard a different tune and got his undergraduate degrees in music education and music composition.

"I have a different background," he admits, adding that the great modern composer Charles Ives ran an insurance agency in Danbury, Connecticut, for most of his adult life. (Scheffler continues to compose choral music and enjoyed the premier performance of a new piece last month.) "But it's one that correlates so beautifully to investment management. Composition is about choices, it's about architecture, it's about analysis, it's about balance, it's about knowing how to make adjustments, and decision-making. That's exactly what investment management is as well."

After graduation, Scheffler spent three years teaching at a junior high school in Kenosha, Wisconsin. When he got married he moved back to Appleton, Wisconsin, where he'd gone to college, and took a job with a local brokerage. He intended to be out of teaching only a year, but stayed with that firm for six times as long.

"I was a lousy broker, to be honest with you, because I never really bought into the idea of selling a product," he recalls. "I didn't think that selling a product would necessarily do good things for my clients. It ended up doing pretty great things for me, but when the markets turned, you really couldn't do a whole lot to add extra value. You couldn't manage risk."

The desire to help his clients manage the risk inherent in their investments, rather than passively accept it, was what led Scheffler to found Appleton Group Wealth Management in 2002. He's quick to point out that managing risk is not the same thing as eliminating it—he could eliminate risk for many of his clients, but that would mean limiting their returns to 4% for the next decade. "That's probably not a high enough return to make a financial plan work," he says. "A lot of clients have to incur some risk and they can accept it wholeheartedly and live with all the consequences, good and bad, of that, or they can manage it. I think that by managing risk clients can achieve higher returns, and more importantly, compound more dollars, because they don't have to dig themselves out of a big hole."

Scheffler notes that over the last 20 years, returns for the S&P 500 have been 11.9%, but hidden in that return is the fact that in the essentially flat market of the last seven years, investors in the S&P 500 had at one point lost over 44% of their investment. "So accepting risk ends up meaning that you're going to have to take on a whole lot more risk and accept a whole lot more downside with the hope that you're going to be rewarded for that," he says.

THE PROBLEM WITH ASSUMING

Scheffler feels that a good deal of his success in managing risk comes from avoiding some of the assumptions commonly made by other money managers. "There's an assumption that if you accept risk at a given level, that you'll always be rewarded for that risk," he observes. "Sometimes it happens, sometimes it doesn't. Making the assumption that you'll be rewarded for a high-risk portfolio, to me just doesn't make a lot of sense, when the consequences of being wrong can be pretty dramatic. They can be life changing, and that's something we just don't have an interest in."

To put his risk management theories into practice, Scheffler has developed what he calls the Appleton Group Wealth Management Discipline. "It's built off the premise that portfolios need to be flexible," he explains. "That's nothing new, but the way we do it is to diversify not only by what's in the portfolio, but how those assets

Photography: Jeff Lendrum

are managed. We diversify by wealth management style."

The portfolios that Scheffler has developed use a combination of both active and passive management. "By knowing that there are different types of market environments that we definitely want to address and that we want to add value in, we can constantly play those two disciplines off of each other," he says. "So if our active piece beats our passive piece in a year, we rebalance and sell off part of the active piece and buy more of the passive. When the passive outperforms, we do just exactly the opposite. This is a beautiful way for us to consistently buy low and sell high."

This discipline has allowed Scheffler to create what he calls "ultra-efficient" portfolios. To gauge the efficiency, he looks at returns over a full market cycle and then compares that number to the worst one-year returns. "Consistently our returns have been higher than what our loss has been in our worst year," he notes. "So an efficient portfolio is one that's up 12% on average per year and in its worst year only drops by 4%. That's consistent with what we've accomplished on all six of our separately managed accounts."

Of the SMAs that Scheffler has developed, three comprise only ETFs, while the remaining are asset allocation portfolios using mutual funds. The minimum in any of the SMAs is $1 million, "but inside a 401(k), when you get down to the account level, they can be used starting at zero dollars. That's primarily how they were built—to be used primarily for 401(k) individual accounts. What we wanted to deliver was the same type of wealth management discipline that formerly was available only to the largest of institutions and bring that down to a retail level."

THE FUTURE

For many advisory firms the biggest challenges have to do with issues of ownership and future growth. Although his firm is only five years old and has a total staff of five, Scheffler has invested heavily in the future. "We're at $91 million in total assets now, but we have enough capacity to get up to $1.3 billion without changing our internal structure," he says. "We've really thought ahead about how we want to grow our business over the next decade."

When the founders of many firms use the first person plural, it's more in the sense of how Queen Victoria used it and not an expression of community. Scheffler really does mean "we" however, due to the unusual ownership structure that he's instituted. "All of our employees are co-owners of the firm," he reveals.

Scheffler wanted to be sure that the firm's compensation was tied to its clients' success. "The fee-only model allows that to happen absolutely," he says. "The more we make for our clients, the higher our fees go. If our clients lose money, then we have to take a pay cut. It means that risk management is more than just an afterthought. It's the lifeblood of what we do."

For many firm owners it's really hard to let go of the thought that they started the company, they took the risk and all, or certainly most, of the rewards should be theirs. Scheffler feels that all employees should have a personal stake in how well the company does. "Typically what we would do is grant equity ownership to employees as they come on board and then they become vested over a two- to five-year time period, depending on the position and depending on how much they are granted," he explains.

If an employee/stakeholder leaves the firm they retain their vested stake. They have the option of holding on to it and continuing to share in the profits or they can sell it back to the firm, which has the right of first refusal on any sale. So far two employees have left (one moved out of the area, the second went to work for a local competitor) and both have kept their shares.

PRACTICE, PRACTICE, PRACTICE

Scheffler has structured his practice with three distinct client groups sitting side by side in harmony. The first and most important is the private client group comprising 95 high-net-worth families and individuals, primarily in northeastern Wisconsin. Clients in this group must have investable assets of at least $1 million and Scheffler estimates that he could take on another 50 or so families of that size without putting any strain on the organization.

The other two components of Scheffler's long-range plan involve 401(k) plans and institutions. Both of these areas are relatively small right now, but have potential for much greater growth.

Right now the firm manages about $5 million in 401(k) assets, but is in the process of bidding on several other plans with considerably higher asset levels. "We're in the fifth year of a bull market and just like in 1999 a lot of plans aren't moving because people are so happy," he says. "But we all know what happened right after 1999. We have a motto that we sort of live by: 'Be prepared to question answers as much as to answer questions.' On the 401(k) side the biggest question is, 'Are we positioned properly for good markets and bad?' A lot of times plans and individuals just aren't prepared for that. They make the assumption that the market only goes in one direction."

Appleton Wealth Management provides three 401(k) services: plan advisor; investment manager for those plans; and certified fiduciary advisor, a designation coming out the Pension Protection Act, which Appleton was the first firm in Wisconsin to receive.

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Year firm founded: 2002
AUM: $91 million
Number of clients: 95 families and individuals in private client group
Client minimum: $1 million
Compensation: fee-only
Education: BA in music education and music composition, Lawrence University
Previous incarnations: junior high school music teacher; broker

"One of the goals I had from the get-go was to establish a private client practice that we could serve with distinction and then expand that to areas in which we would offer a whole lot more help," Scheffler says of his entry into the 401(k) arena. As an example, he cites a client who came to him last year. She had worked for a local manufacturer for 20 years and over that period the returns on her 401(k) were identical to those predicted by the Dalbar quantitative analysis of investor behavior study—3.9% per year. "You look at that number and say that can't possibly be right, but the data is good data," says Scheffler. "If investors are only making 3.9% a year and they need to make between 6% and 9% in order to make their financial plans work, then the 401(k) area really has been a failure from an investment standpoint. It's great to get people to save, but if the net returns aren't high enough to sustain that income stream that they need over their lifetime, then 401(k)s aren't doing the kind of work I really think they should be doing."

The third note in Scheffler's business plan involves serving institutions. His only client in this area so far is the Community Foundation for the Fox Valley Region. "One of the issues that we've addressed there is not having as much dependence on the market to produce our returns," he says. "When the economy is doing poorly is when a community foundation's assets are needed most. The community foundation supports the United Way, and the YMCA locally, and all kinds of women's issues and domestic shelters. We want to make sure we're in a position to produce good gains to fund those projects."

Although Scheffler's primary focus is on his high-net-worth private client group, 401(k) plans and institutions, he doesn't want to leave any opportunities unexplored. That and his desire to truly serve the 401(k) marketplace led to the establishment of a proprietary mutual fund, which Scheffler says, is designed to deliver the firm's wealth management discipline to 401(k) plans and to smaller individual accounts. The fund is actually a fund of funds made up exclusively of ETFs. "We're constantly trading ETFs within that fund with the sole purpose of increasing or decreasing an overall portfolio's exposure to the market."

The Appleton Group's SMAs and mutual fund are available to other advisors on a number of platforms, including Schwab's and Fidelity's. There are no commissions or loads attached and the 12b-1 on the mutual fund is a modest 25 basis points. By restricting his private client group and focusing on developing his institutional business, Scheffler hopes to make his services more attractive to other local advisors. "We don't really want to compete with them. I think that they should be looking at what are the more efficient vehicles in the marketplace to meet their clients' goals and I think we fit that bill." **IA**

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