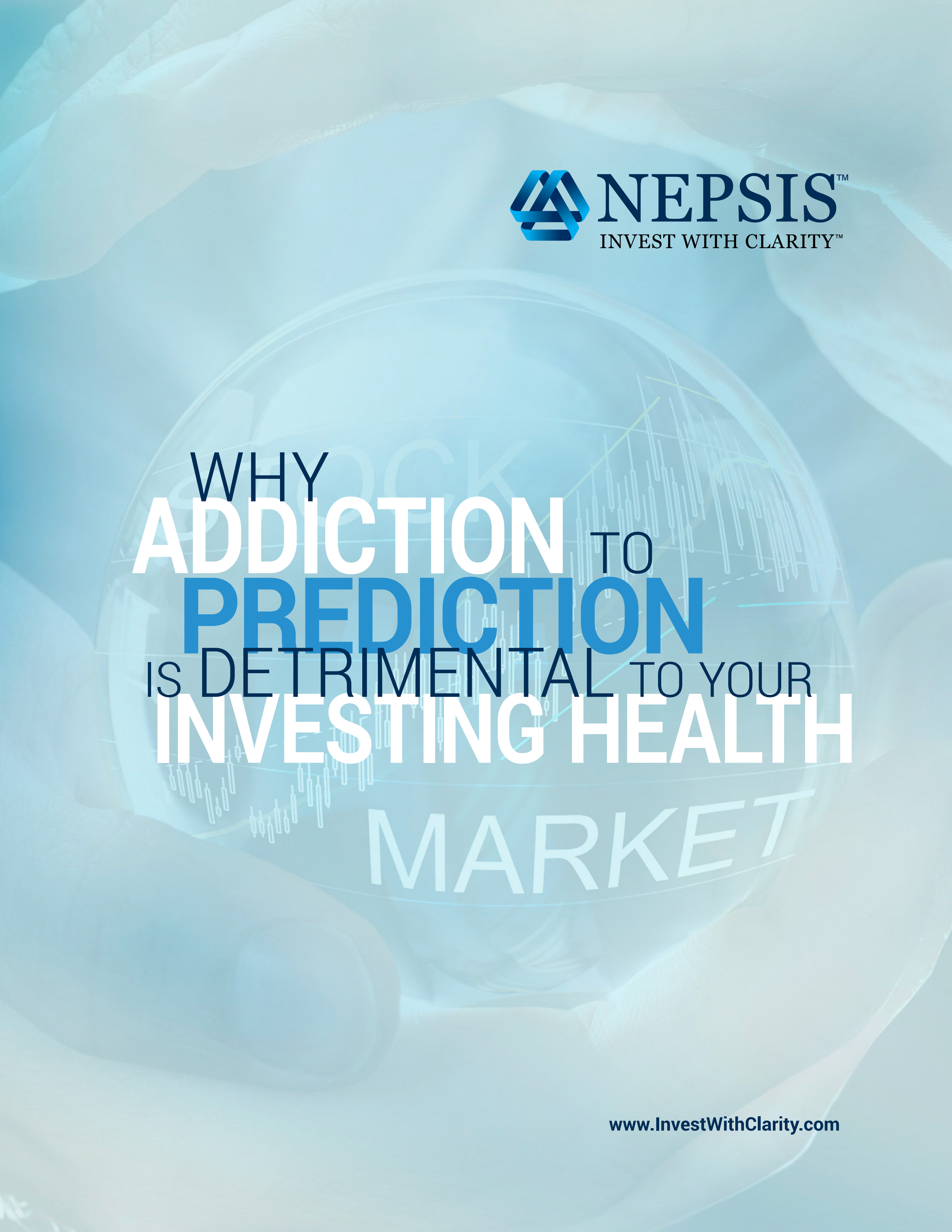

NEPSIS™
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WHY ADDICTION TO PREDICTION IS DETRIMENTAL TO YOUR INVESTING HEALTH

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OVERVIEW

WITH THE STAGGERING EVIDENCE SUPPORTING HUMANS' INABILITY TO PREDICT THE FUTURE, WHY DO INVESTORS RELY SO HEAVILY ON USING FORECASTS TO MAKE INVESTMENT DECISIONS? MANY INVESTORS KEEP PREDICTIONS OF MARKET EVENTS AT THE CENTER OF THEIR INVESTMENT PROCESS.

ADDICTION TO PREDICTION

Investors, like all people, are drawn to predictions; especially those that play to our natural fears of the unknown. Many of these portents and projections are intentionally constructed in a storytelling format designed to alleviate our anxiety over being uncertain.

In our industry, how many times have we been subjected to the age-old question, "What do you think the market is going to do?" Despite the fact that we actually do not know what will happen, we feel compelled to give an answer. It may be best for us to take the advice of a famous Chinese proverb (attributable to Lao Tzu), "Those who have knowledge don't predict and those who predict don't have knowledge."

This paper hopes to address investors' fascination with forecasts and their apparent addiction to prediction. We believe that investors' overconfidence and anchoring is what draws them to the allure of prognostication. In the end, overconfidence leads to arrogance and anchoring leads to ignorance. These are very undesirable traits whether related to investing or not.

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8674 Eagle Creek Circle, Minneapolis, MN 55378
(952) 746-2003 • Fax: (952) 746-2006 • www.InvestWithClarity.com
Blog: www.InvestingWithClarity.com I Radio: www.InvestingSuccessForYou.com

Our goal is to provide investors and advisors alike with remedies that permit us to stop relying on this pronounced addiction for futile forecasts and to focus on the important aspects of wealth creation.

The fact is, investing is an inexact science and it will always have an aspect of uncertainty. Additionally, investors do their decision-making abilities a great disservice when they resign themselves to a state of denial concerning uncertainty in their investing. The result of this resignation is ambiguity… the polar opposite of clarity. While many feel it may be counter-intuitive to embrace uncertainty, doing so has been proven to enhance decision-making skills and far outweighs the damaging effects ambiguity can have upon investors. Ambiguity renders investors that are unable to manage the factors they can actually control; such as knowing what companies they are invested in and why. As the philosopher Confucius stated, "To know that we know what we know, and to know we do not know what we do not know, that is true knowledge"; it's best to accept what you can and do know, as well as what you can't and don't know.

> …embrace uncertainty, doing so has been proven to enhance decision-making skills and far outweighs the damaging effects ambiguity…

Why do Investors Insist on Using Forecasts in the Investment Decision-Making Process?

We propose the first reason is a result of investor ignorance. We say this because most investors do not have a clear understanding of what they own and why they own it. Thus, they harbor under the veil of uncertainty. To soothe this fear of uncertainty, they anchor their hopes or latch onto any data points, regardless of how irrelevant they may be, to substantiate their portfolio decisions. The Behavioral Bias of Anchoring permits people to continuously subject themselves to meaningless predictions despite their ineffectiveness. **It was Albert Einstein, the great scientist of the 20th Century who said, "Doing the same thing over and over again and expecting different results is the definition of insanity." Why do we continuously expect different results? We suggest two reasons: denial of uncertainty and the allure of storytelling.**

Many people, especially investors, analysts and money managers, are overconfident about their ability to predict the unpredictable. While this keeps soothsayers, palm-readers and psychics in business, it is a terrible way to build an investment portfolio. Embracing uncertainty (knowing that you cannot control the future) or at least having a healthy respect for it, leads to better decision-making. We subscribe to the thought process of Daniel Boorstin, the great 20th Century American Historian who said, "The greatest obstacle to discovery is not uncertainty but the illusion of knowledge."

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Acknowledging uncertainty allows money managers to focus on the probabilities of outcomes rather than conjectures. This allows us, here at Nepsis, to focus on the following market precepts (based on Ibbotson research) as opposed to forecasting the markets:

{ **SINCE 1926, OWNING BUSINESSES (INVESTING IN EQUITIES) HAS BEEN THE GREATEST PATH TO WEALTH CREATION - EARNING 10.2% VS. BONDS AT 5.5%.** }

(Source: 1926-2012 Ibbotson Yearbook, 2017)

{ **THE STOCK MARKET HAS PRODUCED A POSITIVE ANNUAL RETURN 74.7% OF THE TIME AND A NEGATIVE RETURN 24.3% OF THE TIME.** }

(Source: https://seekingalpha.com/article/4123720-stock-returns-uncommon-average?page=2)

{ **SINCE 1926, THE MARKET HAS ONLY HAD FOUR ROLLING TEN-YEAR PERIODS WHERE THE RETURN WAS NEGATIVE.** }

(Source: https://www.ftportfolios.com/Common/ContentFileLoader.aspx?ContentGUID=dd931c20-3a5e-4306-9d22-658ef9e4e3c4)

{ **THE MARKET HAS NEVER HAD A 15-YEAR PERIOD WHERE RETURNS WERE NEGATIVE.** }

(Source: 2018 Fundamentals For Investors)

{ **FROM 1926-2014, DIVIDENDS MADE UP 43% OF THE TOTAL RETURN OF EQUITIES AVERAGED OVER ROLLING FIVE-YEAR PERIODS.** }

(Source: https://www.brandes.com/docs/default-source/brandes-institute/2015/income-as-the-source-of-long-term-returns.pdf)

{ **LONG-TERM INVESTING FAVORS VALUE EQUITIES. ACCORDING TO BRANDES INVESTMENT PARTNERS SINCE 1968, THE CHEAPEST ONE-TENTH OF U.S. EQUITIES RELATIVE TO PROJECTED EARNINGS HAVE OUTPERFORMED THE MOST EXPENSIVE ONE-TENTH BY 9.1% A YEAR ON AVERAGE.** }

(Source: https://www.brandes.com/docs/default-source/brandes-institute/2015/income-as-the-source-of-long-term-returns.pdf)

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Based on the aforementioned statistics, the likelihood of generating wealth from owning companies is undeniable, especially those that are value-oriented and issue dividends. We readily admit that we do not know what the fluctuations in equity prices will be on a day-to-day, month-to-month or year-to-year basis.

This is something that nobody has access to, something many are unwilling to admit, fooling themselves and investors. By focusing on the probabilities of outcomes and the likelihood of an event, we can have a greater sense of honesty in our philosophy and provide investors with the clarity they deserve.

The second way investors exhibit ignorance is through their reliance on stories when gathering information. According to Hastie and Pennington's ground-breaking research in 2000, known as, "Explanation-Based Decision Making", people rely heavily on stories to reach decisions. Their work focused on a broad range of evidence gathering topics, but can be readily applied to investing. The central theme of the research states that the person making the decision (the investor) constructs or is told a story and then uses this story rather than the original evidence as a basis for their final decision.

{ WE ALL HAVE HEARD THE FOLLOWING AT SOME POINT: }

1

"I HAVE A GREAT 'STOCK TIP' (STORY) FROM MY BROKER."

2

"THAT WHOLESALER HAD A VERY COMPELLING ELEVATOR PITCH (STORY)."

3

"I HEARD THAT MONEY MANAGER SPEAK AT A CONFERENCE AND REALLY LIKED WHAT THEY HAD TO SAY (STORY)."

The list is endless of how investors get duped into what appears to be plausible sounding stories but at the end of the day they remain mired in disappointment. Unfortunately as the research suggests we construct portfolios on appealing stories and match the story to possible decisions rather than truly weighing and evaluating the evidence. True clarity is not gathered from a whippy anecdote but by profoundly understanding the money manger's core philosophy and strategy.

The second reason that investors rely on the pursuit of forecasting in their decision-making process is rooted in arrogance or overconfidence. According to Investopedia, the behavioral bias of Overconfidence can be defined as, "Overestimating or exaggerating one's ability to perform a task or an overly optimistic assessment of one's knowledge or control of a situation." Furthermore, in a 2006 study (source: "Behaving Badly", by researcher James Montier) found, "That 74% of the 300 professional fund managers surveyed believed that they had delivered above-average job performance. Of the remaining 26% surveyed, the majority viewed themselves as average. Incredibly, almost 100% of the survey group believed that their job performance was average or better. Clearly, only 50% of the sample can be above average, suggesting the irrationally high level of overconfidence these fund managers exhibited."

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To make matters worse an extensive study by Pam Dunning and colleagues in 2004 (source: "Why People fail to Recognize their own Incompetence") noted that the worst culprits are those that are the most inept at doing their jobs.

The study documented that the worst performers are generally the most overconfident. For example, college students who scored in the bottom 25th percentile of a course exam felt they were about average. The same held true for debate teams and medical students. Their conclusion, "such individuals suffer from a double curse of being unskilled and unaware of it." We see this in the investment world all the time as the economists, analysts and money managers who proclaim with bold assertion their ability to predict the future usually are the ones who make one "lucky call" only to be followed-up with poor predictions while blaming it on outside forces.

> The job of an analyst is to analyze factual information not postulate about the unpredictable.

We fully believe that this dynamic is present in the investment industry as the Montier study validates. This also can be supported by the plethora of mutual fund managers who fail to beat their own chosen benchmark over numerous time periods. Applying the Dunning Study to this construct, the worst money managers are usually the ones with the boldest "predictions" which likely comes from their state of overconfidence or arrogance.

The simplest and most obvious answer is that we need to stop relying on senseless and irrelevant forecasts because they simply do not work. A great read is Nassim Taleb's book the Black Swan where he documents the failed attempts of Wall Street to predict future market happenings. He refers to this as the, "Scandal of Prediction" and documents numerous examples of bungled forecasts. Our favorite may have been the one where a large unnamed Investment Bank analyst who in May 2008 predicted $200 oil to be around the corner only to be followed by a revision in September 2008 down to $114/barrel when in fact oil fell to $70/barrel by that year's end and fell to $33/barrel in May 2009. As of the drafting of this paper in May 2018 and nine years later, WTI Crude Oil sits at $68/barrel.

What really raises our ire is the fact that no one ever seems to be held accountable for these outlandish market calls. If the truth be told, economists are good at one thing and that is telling you what just occurred and why. Moreover, there is a legitimate reason that analysts/economists are not referenced as forecasters because no one would believe what they said by the mere title of their duties. The job of an analyst is to analyze factual information not postulate about the unpredictable. Other than that, employing a dearth of analysts/economists to forecast the future in our estimation is a misuse of resources.

So What Can be Done to Break this Endless Chain of Addiction to Prediction?

Now that we have hopefully established the futility of predicting future market happenings, how do we break this deep-rooted seed of addiction to it? We suggest the following:

- First and foremost, investors and advisors need to focus on the destination rather than the journey. Investors place entirely too much emphasis on day-to-day and near-term market performance. As an investor, determine what you are trying to accomplish and align that with an advisor and money manager who both relish those same tenets.
- Stop pinning hopes on market calls, short-term tactical shifts and algorithmic machinations in generating market returns. Instead, rely on the long-term historical precedence stipulated by facts and supported by wealth generation created by owning solid businesses over the long haul.
- Locate a money manager who concentrates on a few key elements in the selection process and is able to readily and clearly articulate those to you. There are several strategies that don't need forecasts as inputs, such as intrinsic value and dividend capturing. We call this clarity of philosophy and strategy.
- Do not believe everything you read. Hyperbole is rampant in today's environment on both the ultra-bearish and bullish side. Detach the ripcord to spurious anchors that soothe our fears of uncertainty. Embrace uncertainty (investment world calls it volatility) and make it your ally. An honest assessment of differentiating between what we know and don't know is emotionally healthy... remember the quote from Confucius.

Let us close by referencing our 2018 Market Outlook and our "Top Ten Predictions" for the forthcoming year. We hope you enjoy them because they will most likely be our Top Ten Predictions for the next 50 years!

1. Most predictions on where the S&P 500 will end in 2018 will be wrong.
2. Company stock prices will move up and down irrationally—what else is new?
3. There will be opportunities to purchase great companies on sale—there always are!
4. Timing the markets will continue to be difficult.
5. Focusing on short-term performance will distract investors from making intelligent long-term investment decisions.
6. Some investors will let emotions get the best of them.
7. Investors will purchase stocks that were "top picks" and sell them too soon, once again by focusing on short-term results.
8. Smart investors will be patient with their investments—like we are at Nepsis.
9. As it always does, stock market volatility will continue to scare investors while creating great investment opportunities.
10. Many investors will grow frustrated with predictions because they were wrong.

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For more information contact:

Nepsis™, Inc.
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8674 Eagle Creek Circle, Minneapolis, MN 55378
www.InvestWithClarity.com
Blog: www.InvestingWithClarity.com
Radio: www.Investingsuccessforyou.com
