

Behavioral Finance: The Logic of Emotions

by Joseph W. Jordan

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One of the ill effects of the modern age of technology is the de-emphasis on the emotional or behavioral part of the human thought process. Many articles have been written during this financial crisis about how individuals have to take emotions out of investment decisions. However, this idea negates the fact that humans make decisions with “two minds” and therefore, cannot deny the role of emotions.

The realistic way of approaching this issue can be taken from a quote by Nick Murray, a well-known financial industry financial professional. He says, “one’s belief system, rather than any intellectual understanding of the economic situation, will dictate the appropriate behavior.” And the belief system has very little to do

with left brain logic. People used to believe we are thinking creatures who feel, but we’re really feeling creatures who think.

THE ROLE OF BEHAVIOR IN FINANCE

Most financial and economic models assume that the individual will make rational decisions, but individuals don’t always act rationally. When markets go up, most people think it will continue to go up. When it goes down, most think it will continue to go down. Price is in the inverse of value and individuals should always buy weakness and sell strength.

Therefore, the models employed in the financial services industry to predict and maintain investment outcomes are based on the misunderstanding of the role of emotion with money. Many in the field of behavioral economics believe that disconnect is at the root of many problems, one of them being how financial professionals and their clients connect.

The late Sir John Templeton, the pioneer global investor who devoted his fortune to answering questions of science, religion and human purpose, said that bull markets are:

Born on pessimism;
Grow on skepticism;
Mature on optimism; and
Die on euphoria.

What Templeton and other behaviorists are trying to convey is that individuals make decisions using the right side of the brain; the emotional side.

YOU CAN’T MANAGE PERFORMANCE

People tend to focus on short term performance, but performance is not a goal. What financial professionals can manage is behavior and the client relationship. In other words, they must find a way to get clients to participate in their solution because clients take action for reasons they come to on their own. Quite frankly, clients don’t really want to know how the products work; they want to be heard. Financial professionals always have to help people avoid concentrating on what they just experienced, and more on their long term financial goals.

According to a recent MetLife Omnibus poll, more than half of respondents stated that when looking for a financial professional, they would look for someone who is proactive in keeping them informed of their situation and who can provide products that protect them against market risk. Understand that the financial instruments people buy are tools to help them achieve their goals, they are not a means onto their own.

Therefore, it is important that listen to what the clients need, not what you think they should have. Ask clients about family and their lifestyle today and tomorrow; ask them about their biggest fears and their dreams; etc. This is all a part of building a relationship. Think about the time and effort individuals put into personal relationships with family, friends, children, love interests, business partners, etc. It rarely happens overnight.

Once a client is comfortable with a financial professional, it’s time to remind them of the value this industry offers them such as:

- Providing *protection* when a family loses its primary wage earner
- Delivering *independence* when clients are disabled
- Offering *dignity* when clients can no longer take care of themselves
- Ensuring a *legacy*

It’s at this point that a financial professional can and should make the appropriate product recommendations, but not before understanding how your clients feel.❖

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