Impulse is Bliss

Older but wiser? Don't count on it. New brain research shows exactly how much help sixtysomethings need with financial decisions, and it's a lot.

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The capacity to make decisions, including financial decisions, changes dramatically over the life cycle. The young may enjoy greater cognitive abilities-innate mental processing skills peak at around age 20, akin to peak physical performance-but the old have more experience to bring to bear on practical matters. People age 50 or older-in other words, the bulk of your clients-also have a different outlook on life, characterized by a different mood, from the young. They are happier, according to most psychological research, and their sunny outlook influences their financial decisions.

Research into how the elderly make decisions is one of the hottest areas of behavioral finance right now. The conclusions are often counterintuitive and even unsettling. The aging brain puts even the most detail-oriented, accomplished seniors at ease with impulsive moves and therefore leaves them vulnerable to scams as well as plain old poor decisions. Everything will work out, they tell themselves-they're here, aren't they? Therefore, it behooves financial planners to familiarize themselves with these very new findings from neuroscientists and other researchers in order to help their elderly clients.

What is the defining characteristic of the elderly client? "Vulnerability," says Nicole Maestas, an economist at the Rand Corporation, the Santa Monica, Calif.-based think tank. "A 40-year-old could easily have problems handling complex financial decisions, but the problems are much worse in a 65-year-old, and the difference is clearly age-related," she says. We are not talking about Alzheimer's or dementia here, but about fully functioning individuals. Maestas studied people's ability to navigate the Medigap insurance market. These plans are highly standardized, and yet people pay wildly different prices. Maestas calls the disparity "puzzling." According to standard economics, people should buy the lowest cost product, she says, but that wasn't the case.

Why not? According to Maestas, the decision is so complex that people turn to insurance agents for help-and whether the advice is bad or good, they take it. The price variation "shows the vulnerability of the elderly when facing agents" as well as their inability to determine the lowest-cost policy on their own. Medigap purchasers tend to be the affluent and well educated, yet even these consumers are making poor decisions and are vulnerable to their agents' sales pitches, Maestas adds.

At the same time, as Maestas points out, "there is heterogeneity in the pace of the decline." Not all the elderly are equally marked by diminished decision-making ability, with the highly educated tending to be more resilient. Nonetheless, in general, the old are different.

THE POSITIVITY EFFECT

Though the elderly are often described as irritable, like in the title of the classic movie, "Grumpy Old Men," the opposite is more typical. The old are in fact more positive than the young. "Dozens and dozens of studies show that as people age they become less interested in negativity and more interested in the positive," explains Lisa Feldman Barrett, a neuroscientist at Boston College.

The "positivity effect" of divesting yourself of what is negative and not rewarding as you age, is found across numerous domains. Take social life: When you are young, you can put up with a lot, including difficult but interesting friends. But when you reach middle age, according to Barrett, you are likely to drop high-maintenance friends and difficult people. Over time, your social network shrinks but you actually derive more pleasure from socializing.

This search for positives and avoidance of negatives can be traced all the way to how people use their vision at different ages. In a 2006 experiment, Derek Isaacowitz of Brandeis University's Emotion Lab showed emotion-evoking images-a smiling baby and an accident scene-to individuals in their seventies and in their teens, and then measured the duration of their gazes down to the millisecond. Seniors, much more than teenagers, gravitated toward the positive image. The difference in gazes averaged a full two seconds. This experiment has been replicated countless times, with the elderly consistently spending more time gazing at positive images compared with the young. As for avoiding negative images, again the differences are large, over two seconds.

THINK HAPPY THOUGHTS

Positivity is found in both the memories of the elderly and their forecasts of likely events. They are less likely to remember details of negative incidents, and more likely to predict a positive, albeit vague and undetailed future. "Older people don't imagine the future very well," Barrett says. "They can do the general gist, but they can't fill in all the details." For example, she says, healthy 60-year-olds, asked to forecast a typical day in retirement, tend to have a rosy view, heavily influenced by the present: "They don't anticipate their health will change, or the loneliness," Barrett says.

Why the elderly are so positive is subject to debate. It could simply be emotional maturity: Why sweat the small (and negative) stuff? Life's too short.

Barrett's research and that of most behavioral finance academics is focused on changes in the brain. Over a lifetime the brain shows a decreased responsiveness to negative stimuli.

The change is seen most obviously in the amygdala, a brain structure in the temporal lobe that appears to play a key role in emotional processing as well as in regulating attention and memory. The amygdala of an elderly person, according to Barrett, doesn't respond as strongly to negative stimuli as the brains of the young. "It gets less sensitive to negative stimuli over the life cycle," she says.

The question is, What does positivity mean to your clients' finances? "A lot," Barrett says. In a forthcoming paper entitled An Affective Science Perspective on Age-Related Challenges in Financial Decision Making, Barrett and her co-authors from the Boston College Center for Retirement Research conclude that "increased attention to positive information... is a recipe for optimistic, but not necessarily realistic, financial planning." This compounds the challenges of anticipating the daily reality of the future, such as the retirement years.

Because of their bias toward the positive, the elderly may underestimate risks, ignore details, and in general, make sub-optimal financial decisions based on, in Barrett's words, an overly "bright but blurry future." Scamsters take full advantage, which is how they convince the elderly, over a free lunch, that they can double their retirement portfolios-with a patented no-fail strategy!-in just 15 months.

There is a solution. Financial planners can help elderly clients overcome their bias toward positivity by forcing them to sweat the small stuff and fill in the details they would prefer not to dwell on. "You have to highlight risks, to get people to pay attention to the downside," Barrett says. Paint a vivid picture. Sales brochures may say that a structured product, to use a vintage 2007 example, is a no-fail proposition. You know better, and can fill in the blanks about how things may go wrong.

Rather than saying an investment holds a 10% risk of a catastrophic loss, Barrett says, fill out the scenario with what this loss might mean in everyday terms, such as being forced to sell a house or forgo vacations. In other words, make numbers-particularly risk numbers-meaningful by translating them into real-world terms.

Psychology researchers have found other ways that planners can help their aging clients make better financial decisions. Hal Ersner-Hershfield, postdoctoral fellow and professor at the Kellogg School of Management, who studies the role of emotion in retirement planning, has an imaginative but practical suggestion: Ask clients to have a conversation with their future self. Says Ernser-Hershfield, "Tell them to have a conversation with the person they think they will be in many years' time. Will they be happy then with the decisions they are making today?" This forced conversation makes the tradeoff between today and the future more understandable, and the decision at hand worthy of more study.

COGNITIVE DECLINE

Implicit in researchers' focus on positivity bias is the idea that the elderly are making decisions emotionally, relying on positive moods, rather than thinking analytically. One possible reason is that people's analytical functioning falters as they age, forcing them to rely on mood or intuition. For example, when given tasks that evaluate working memory, reasoning, spatial visualization and cognitive processing speed, there is a decline with age. One common "task" used to evaluate cognitive facility is to show people a list of 10 words and then have them write down as many as they can remember. Despite possible individual variation, there is really no debate-the number drops.

"Analytic cognitive function appears to decline dramatically... starting at age 20," wrote the economists Sumit Agarwal, John C. Driscoll, Xavier Gabaix and David Laibson in their landmark 2009 paper, The Age of Reason: Financial Decisions Over the Life Cycle.

The researchers studied the fees people paid for credit card balance transfers; interest rates; late payment; over limit; and cash advance; in addition to home equity loans and lines of credit; auto loans; mortgages; and small business credit cards. Their conclusion: "cost-minimizing performance occurring around age 53." In plain English, people paid the least and in this sense made best choices at around age 53.

Although, by this time, the research subjects were well past their cognitive prime, they had gained experience as they aged. Hence the middle-aged made fewer financial mistakes.

However, after the mid-fifties, individuals' continuing cognitive decline outweighed their increase in experience and decision-making began to suffer. By age 85, about half the population suffers from dementia or some other medically diagnosed cognitive impairment. This means people have to make the most difficult financial decisions of their lives-when to retire, when to claim Social Security, how to spend down their life savings-at ages when their decision-making ability is no longer at its peak.

This is ultimately a public policy problem. Millions of baby boomers are retiring, many with marginally sufficient savings at best, and they are very likely to make some bad choices when it comes to their retirement savings. So the nation has a large cohort of people who might get into very serious trouble unless the government finds ways to protect them from aggressive sales agents... or perhaps from themselves.

One novel idea presented in the paper is to create "advance directives," the financial equivalent of a living will. A young retiree could direct, for instance, that at age 90 she wants a certain percentage of her assets moved to a safe harbor, such as Treasuries.

Xavier Gabaix of NYU, one of the paper's co-authors, has additional policy recommendations. "It's important to have smart regulatory responses," he says. These could range from more plain English in disclosure documents to more stringent regulatory approval for new financial products. "Certainly, disclosure of the fine print is important, but information overload is a danger," he observes. "It may not be a bad idea to have a Consumer Financial Protection Agency that makes sure that intentionally misleading products can be regulated away," he adds.

WHAT PLANNERS CAN DO

Of course the most obvious solution is to use a financial planner with fiduciary responsibility-though even that is no foolproof solution. Several planners have crafted strategies for working with elderly clients that address some of these mental changes. For instance, Nicolas Nicolette of Sterling Financial Planning in Sparta N.J., deploys unique communication approaches.

Since very elderly clients are often averse to digging into numbers, conversations begin at the general level. If, say, a frail client states the need for independence and dignity, Nicolette then focuses the conversation on how this request translates into practical terms. A continuing-care community that still allows for autonomy could be one solution. "We use different processes for different ages," Nicolette says. "For a younger client we might just start with the numbers. For older clients we work at an emotional connection and then go into the numbers." The end result is a more productive-and positive-experience.

Karen Altfest of Altfest Personal Wealth Management in New York City, has many clients who started with her 25 years ago. Several are in their nineties now. She says, "Older clients, even those in their seventies, forget a lot. It is therefore important to document everything." It can also make sense to talk to the client with a child present. Her ultimate advice for dealing with the older client: "Patience. Old clients have lived a long time and have many stories they want to share. Be a good listener; empathetic listening is an art."

Kathryn Votava of Goodcare.com in Pittsford, N.Y., is a nurse practitioner and a financial planner. She points to another physical issue that correlates with aging: hearing loss, which may lead advisors to assume a client doesn't understand. "Be aware that clients may have trouble hearing you even if they don't admit it," she says.

Votava adds, "In my experience the fundamentals of being simple, clear and direct cut across all age groups." That's a point to bear in mind every day, with every client.

David E. Adler contributes frequently to Financial Planning.