Financial Wisdom and Cognitive Decline in Older Adults

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When I first started out in the investment industry, my mentor was a man in his 80s. He was remarkable in many aspects including his work ethic and treating clients in a special manor. Still, the fact that an eighty-plus-year-old makes financial decisions for himself or others brings up a catch-22. In aging adults, does experience counterbalance deteriorating mental abilities?

Only recently has David L. Laibson from Harvard University and colleagues begun to tackle this potentially explosive question. The reason that it has the capability to ignite a controversy is twofold:

1. an accusation of decline in financial acumen with age could offend some who feel they are more competent than they are;
2. a host of restrictions on aging individuals that make financial judgments is a position that many would find unwelcome.

Laibson's associates in the study were first author, Sumit Agarwal from the Federal Reserve Bank of Chicago, John C. Driscoll from the Federal Reserve Board, and Xavier Gabaix from the NYU Stern School of Business. Their paper, "The Age of Reason: Financial Decisions over the Life-Cycle with Implications for Regulation," can be downloaded from the Social Science Research Network.

The conclusion of this 76 page paper is that older adults experience longitudinal analytic cognitive decline. The authors indicate that this finding is associated with evidence that the same population makes an increased number of economic mistakes compared to those in middle age. The authors offer some political policy remedies.

In an e-mail to me, Dr. Agarwal summarized the importance of the article, "I think ours is the first paper that documents that financial mistakes vary over the life cycle - the old and the young are more prone to make financial mistakes, pay higher fees and interest over 10 different products. We discuss a range of policy initiatives to deal with this issue." Although twenty year olds on up were studied, the authors chose to concentrate on the older age group for the interpretation of the results because financial mistakes made late in life cannot be rectified as readily as they can in youth. In other words, they can be disastrous in the senior group.

Three primary financial choices were studied. One was use of credit card balance transfer offers; the second was estimating the value of a residence for home equity loans and lines of credit; the third was use of interest rate and fee payments. Also, seven other financial options were examined. In all cases, peak performance for advantageous financial choices was about fifty-three years of age. This is what the authors referred to as the "age of reason."

If at age 53, experience and analytic ability cross over to produce an optimal outcome, after that, the decline in cognitive ability begins to override experience. At the most extreme end of the age spectrum, 30% of individuals over 85 years have dementia and another 30% have impaired cognitive function. In other words, 60% of this group has diminished decision making ability. This means making financial choices over 85 years of age is problematical. As alarming, starting at age 53, there is a downhill slope to this grim outcome according to the authors' interpretation of their data.

Laibson, et al. offer interventions to ease the prospect of financial disaster in old age. Their nine policy options range from non-intervention to paternalistic. The most regulatory is the suggestion of using a model similar to that of the Federal Department of Agriculture in which new drugs must undergo extensive testing. The same rigor could be applied to financial products to weed out those that are deceptive or worse.

This exacting approach is surprising since the authors themselves acknowledged that "much of the evidence in this paper (and the literature more generally) is not conclusive" (page 3, first line of the second full paragraph). When asked about this in an e-mail, Dr. Agarwal replied, "We lay out a broad range of responses and discuss the costs and benefits of each, without favoring any single one, precisely because more work is needed."

In a Nutshell (almost)

Statistics regarding mental decline in old age are worrisome. The numbers show that 30% over 85 years of age have dementia and another 30% have impaired cognitive function. This means that the majority of older seniors potentially require someone else to make vital financial decisions for them. This information is important for aging investors and elder financial managers plus their families to appreciate.

Laibson's and colleagues' data add to the above by showing that a noticeable decline in brain function begins at 53 years of age. It is then that wisdom begins to be offset by deterioration in financial decision making. Between 53 and 85, there is a continuing decline. The authors propose interventions that could soften the potential disastrous outcome of poor decision making ability in the elderly. However, they offer no guidance as to how to find those who really need help and exempt those who don't. This is an area ripe for further investigation. The really good news is that the question is being addressed and ready to be more completely answered.