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Sad but true: Financial smarts depreciate as we age

By Brent Hunsberger, The Oregonian
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It's tough growing old, especially when it comes to managing money.

Several recent studies reinforce that. Retirees need to act carefully and even seek help in selecting loans, credit cards and Medicare drug plans. That's not just to protect themselves from untoward children or salespeople; it's also to protect them from themselves.

At the same time, some researchers say the warnings on how much younger families need to save for retirement are a bit over the top.

Now that you're completely enraged with me, here's the good news/bad news about money and growing old.

Medicare note

Last week's column on Medicare contained the 2009 deductibles for Parts A and B. The amounts have since been updated: For 2010, deductibles will be $1,100 for Part A and $155 for Part B.

Age of financial reason

We know financial literacy among youths is low, but a new study found the level among older people is "even scarier" than previously thought.

Researchers from Dartmouth College and the University of Pennsylvania say they find that people 55 and older "lack even a rudimentary understanding of stock and bond prices, risk diversification, portfolio choice and investment fees."

When you consider "that individuals are increasingly required to take on responsibility for their own retirement security, this lack of knowledge has serious implications," they say **in a paper** for the University of Michigan's Retirement Research Center.

There's also a significant gender gap. Older women show much less financial sophistication and ability to perform financial calculations than men, says Annamaria Lusardi, a study co-author and Dartmouth economist. This is true in other parts of the world as well, she says, including Italy, Germany, the Netherlands, Russia and Mexico.

These findings echo those of the Federal Reserve, whose economists put the **Age of Reason** regarding finances at around 53. That's when people borrow at lower interest rates and pay fewer fees on loans and credit cards, relative to younger and older adults, they say.

The reason? Younger people are less experienced with financial concepts such as interest rates, says Sumit Agarwal, an economist at the Federal Reserve Bank of Chicago. And the ability to process information related to those concepts declines rapidly with age.

Middle-aged folks are at a "decision-making sweet spot" -- lots of experience but no significant decline in their mental processing.

Experts don't know how best to address these problems. More disclosure would help, Agarwal says. Some say mandatory safe harbors that automatically shift a retiree's nest egg into annuities, bonds or a life-cycle mutual fund would help. Some nations do this. A financial driver's license would be required to opt out of such an arrangement.

For now, though, the elderly and their kin should be aware of their vulnerabilities -- and the need to be vigilant and protective of their money.

How much to save?

You've probably seen this retirement planning rule of thumb: If you want to maintain your current lifestyle, plan on needing 70 to 85 percent of your current income in retirement. Knowing that, you and/or your adviser (or online calculator) can figure how much you'll need to save over time to get there.

But researchers at the University of Wisconsin are skeptical. John Karl Scholz, an economist at the Madison campus, says the rule overstates what most singles and couples with kids need.

Families, he reasons, devote much more of their income to their children and therefore are more accustomed to a lower standard of living.

"The couple with no kids can get used to driving a reasonably late-model car, taking vacations in the warm weather during the winter and eating out once a week," says the father of three girls. "The couple with four kids drives the beat-up station wagon. Their vacations tend to be car camping, and they eat tuna out of a can once a week."

Nearly half of the population can get by with less than 65 percent of their average annual income during working years, Scholz estimates **in another paper** for the Michigan research center. Singles can get by on even less: 55 percent.

That could be a relief for those of us who've been led to believe we're not saving enough by the default parameters at CNN Money's Retirement Planner and Fidelity's myPlan Retirement Quick Check.

It also begs the question: Why is the 70 to 80 percent guideline peddled so hard?

"Rules of thumb are somewhat necessary to cut through the complexity on this," Scholz says. But, "I do think it's in the interest of certain people in the (finance) industry to generate concern about retirement preparation and create fears."

Choices cost money

Last week, after I wrote about Medicare, an insurance agent accused me in an e-mail of needlessly stirring fears.

More accurately, I had bemoaned the overabundance of choice facing consumers. With 44 Part D plans in Multnomah County, it's hard to know where to start.

Turns out, all that choice can be bad for your pocketbook.

Two studies conclude that the vast majority of seniors are not making the most cost-effective drug-plan choices. We're talking just the standalone drug plans -- not the more complicated Medicare Advantage plans.

In 2006, the first year of Part D, fewer than one in 10 enrollees chose the lowest-cost plan, **according to a study** by Jonathan Gruber, an economics professor at the Massachusetts Institute of Technology.

Had they picked the lowest-cost plan, seniors would have saved $360 to $520, on average, based on their actual drug use in 2006, Gruber said.

Of course, retirees might be picking higher-cost plans for good reasons -- because they want access to name-brand drugs or they like a plan's reputation.

But **a more detailed analysis** by Gruber and MIT colleague Jason T. Abaluck found that, even when these other factors are considered, people still made poor choices.

"The problem is when there are so many plans out there, people just get bewildered," Abaluck says. They end up making at least one of three mistakes:

First, they pay higher premiums for plans with no deductible, even though, in their circumstances, low deductibles might not matter.

Second, they pay higher premiums for plans with coverage in the so-called doughnut hole, even though they won't need the coverage. The doughnut hole is the gap where seniors must pay all their prescription drug costs. That gap begins once an enrollee buys more than $2,830 in drugs in one year. It ends once their own out-of-pocket spending exceeds $4,550.

Third, and perhaps most unfortunate, people choose a low-premium plan without fully realizing how it covers the drugs they take. As a result, they spend much more overall, mostly in co-pays, than they would have under another plan.

How can you protect yourself?

The government's **medicare.gov** Web site provides a helpful calculator. It allows you to enter your prescription drugs and compare costs among plans accordingly.

"If you use this online calculator, then you're probably all set," Abaluck says.

Another option is to limit choices. Abaluck's research notes that when consumers are limited to the three lowest-cost plans, they make better choices.

Again, seniors don't pick insurance based purely on costs; they also factor in their health needs.

To that end, Abaluck suggests the following strategy:

Start by picking the lowest-cost plans from three coverage types: low, medium and high.

A low-coverage plan would have no coverage in the doughnut hole but lower premiums or deductibles. Medium might offer some coverage in the hole. High would offer lots of coverage in the hole for higher costs. Do a cost comparison using your drug list and medicare.gov. Then pick what best fits your needs and finances.

Unfortunately, health care reform debated by Congress does not address the choice problem.

It's too bad Congress has saddled its most loyal voting constituency with this kind of burden at a time when they deserve to be celebrating their numbered holidays.

Talk about bad choices.

Brent Hunsberger does not give individual advice but welcomes questions and comments about his column and blog. Reach him at 503-221-8359 or ***brenthunsberger@news.oregonian.com***