Money and Your Mind by Ryan Sager

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The Peak Age of Financial Reason

When it comes to handling your money, do you get smarter every year? Do you get smarter for a while and then level off? Or do you get smarter for a while, hit your peak, and then get less smart every year after that?

It may be depressing to think about, but a soon-to-be published paper on money and aging argues that while our experience and accumulated wisdom make us smarter for a while, this effect is ultimately swamped as our minds begin to decline with age. The tension between these two forces means that the sharpness of our financial decision making rises and then falls over the course of a lifetime, like an upside-down U. The authors of the paper even put a number on the peak of that upside down U: 53.

That's the age, on average, where people's increasing experience begins to be outweighed by the inexorable deterioration of all parts of the human body — including, of course, the brain. As the baby boom generation heads toward retirement, there will never have been so many people with so much accumulated wealth heading into such an extended period of cognitive decline.

What does it mean for society? And what does it mean for individuals hoping to make sure that they and their families are taken care of?

In the paper, "The Age of Reason: Financial Decisions over the Life-Cycle with Implications for Regulation," behavioral economics expert David Laibson and his co-authors find that the prevalence of dementia among Americans "explodes" after age 60, doubling every five years. By age 85, more than 30% have dementia. For Americans between the ages of 80 and 89, roughly half have dementia or a diagnosis of "cognitive impairment without dementia."

"We're living longer, so we're living long enough to experience significant cognitive decline," says Laibson, a Harvard professor. In fact, a host of generational changes have led to the need to worry more about how the elderly handle their money. On top of longer lifespans, people are also accumulating more wealth, making them a greater target for exploitation. Also, the elderly no longer typically move in with their adult children, meaning that someone has to finance their independent living.

The cumulative effect is a lot of people living into old age, a lot of those people needing to have enough money to support themselves, and a lot of those people rapidly losing the capacity to manage their finances.

Laibson and his co-authors measured people's financial performance by looking at how they fared with 10 financial choices: use of credit-card balance transfer offers, home equity loans and lines of credit, auto loans, credit-card interest rates, mortgages, small-business credit cards, credit-card late-payment fees, credit-card over-limit fees, and credit-card cash-advance fees. From this real-world data, they determined what they called the "age of reason," around the age of 53, where people make their most optimal choices over all of the choices studied.

So, what can be done for those who've passed the peak?

Laibson and his co-authors contemplate a basket of regulatory fixes, ranging from requiring greater disclosure on financial instruments, to requiring people to obtain a "financial drivers license" certifying that they're mentally fit to handle their money, to forcing older people to put a large percentage of their assets in a highly regulated "safe harbor" investment.

But that's a pretty big dose of paternalism. And without any action from the government, concerned, aging investors can do plenty of things right now to protect themselves.

First off, they can be smart enough to be concerned. One of our greatest cognitive flaws is not being able to predict our mental state in the future. When we're hot, we can hardly imagine being cold. When we're full, we can hardly imagine being hungry. And when we're lucid, we can't imagine being less lucid years down the road.

The point: While we all think we're going to be fine, we all should prepare for the worst.

Laibson lays out a few simple things a person can do. First, assign someone a durable power of attorney, to make financial decisions for you should you become incapacitated — preferably a spouse or an adult child. This is very easy to do, requiring maybe an hour of work, and can even be done without a lawyer, using forms from the Internet. Another tool, for families with more money, is a revocable living trust.

Another recommendation Laibson makes: Keep your finances simple as you age. "Do not create, at age 50, a super-complicated financial portfolio that assumes a highly sophisticated management style on your behalf forever," Laibson says. Instead, he suggests "a relatively simple portfolio that does not require constant care and feeding," such as low-cost index funds or safe 401(k) plans.

Decline is inevitable. Lack of planning is not.

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