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Protect Your Money from Aging Problem-Solving Skills

As we grow older, our ability to make sound financial decisions degrades, but if we prepare, we can maintain healthy finances well into old age.

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If five people win a lottery and the prize of $2 million is divided evenly, how much will each winner get? If you answered $400,000, congratulations. Your reasoning skills are better than those of half of all Americans age 50, according to one experiment. Here's something even scarier: The same experiment showed that you're sharper than three-fourths of people who are 85 and almost everyone who is 90. That's a glimpse at how our problem-solving skills diminish as we age.

Sumit Agarwal, a senior financial economist with the Federal Reserve Bank of Chicago, says that many simple experiments like this one prove the phenomenon. Worse, other research shows that older Americans "are making mistakes on more-complex decisions involving credit cards, home equity and how to pay for health care," says Agarwal.

For example, consider negotiating a home-equity loan or line of credit. A study by Agarwal and several coauthors has a chart showing the interest rates obtained by people of different ages. The rates start high for borrowers in their twenties, then drop steadily until hitting bottom, a full percentage point lower, for people who are about 50 -- a case of experience trumping youth. However, the rates then rise along with age as people enter their sixties, seventies and eighties. The conclusion: Aging erodes financial acumen.

Experiments show that our reasoning skills drop steadily after peaking at age 53. Add to that dementia, which affects about 1% of the population ages 60 to 64 and rises steeply to about 30% of 85-year-olds.

The decline in reasoning ability as we age poses a massive potential threat to our financial health. Consider that Americans' assets total about $42 trillion -- much of it concentrated in the baby-boom generation. Unlike previous generations, which depended mainly on pensions in addition to Social Security, baby-boomers will be managing much more of their own funds. And boomers face an array of financial choices they'll have to process in those years marked by declining brainpower. Unfortunately, we're wired to avoid taking on these looming financial issues when we're younger and best able to plan for them. We procrastinate, not realizing that we're losing our mental abilities. What's more, we tend to be overconfident that the future is predictable. And because we covet control, we refuse to delegate decisions.

What To Do

Agarwal and his coauthors looked at public-policy remedies, but they didn't find any magic bullets. For example, better disclosure of a financial product's terms makes "surprisingly little difference" in improving financial choices, they say. Other ideas included requiring adults past a certain age to get approval from a third party before making a big financial transaction, as well as enacting new regulations to eliminate "socially undesirable" financial products. It's hard to imagine Americans accepting the former -- or the financial industry allowing the latter.

So we'd better take steps to protect ourselves. **The first step: We need to acknowledge our declining financial acuity.**

One simple remedy is to turn part of your portfolio into, essentially, a pension, by buying a lifetime annuity. Shlomo Benartzi, a UCLA professor and a top behavioral-finance expert, says this removes complex investing decisions from the equation. He also notes that guaranteed income boosts happiness. The downside, he says, is that some retirees especially sensitive to losing money view giving up money in exchange for guarantees as a loss.

The best solution is to designate a financial adviser or family member you trust to handle financial decisions. And do it when you're sharp enough to make a good choice. Consider setting up checks and balances on whomever you select. For example, you could require the adviser to run decisions past a family member or your lawyer.

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