Do Financial Decisions Get Better With Age?

by David Allison
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You hear it all of the time, "age is nothing but a number," but what does age do to your ability to make financial decisions? As droves of baby boomers approach retirement, they will be making increasingly important decisions regarding their finances. Read on to learn how aging can affect your ability to make financial decisions, some of the behavioral traits that older investors exhibit when making decisions, and some tips on how to avoid the possible financial pitfalls associated with aging.

The Age of Financial Treason?

According to the study "The Age of Reason: Financial Decisions Over the Life-Cycle with Implications for Regulation," the average person's peak financial decision making age is around 53 years old. The authors of this study surveyed the life-cycle patterns of financial mistakes using a database that measures ten different types of credit behavior. The financial mistakes noted included suboptimal use of credit card balance transfer offers, misestimating the value of one's house, and excess interest rates and fee payments. The study found that middle-aged adults make fewer financial mistakes than younger and older adults.

According to the study, our ability to make sound financial decisions increases sharply in our 20s and 30s, levels off and peaks in our 50s, then begins to fall sharply in our 70s and 80s — the so called "inverted U". The learning curve associated with gaining financial knowledge is believed to be the reason for the rise in our early years, while declining cognitive function is believed to be the reason for the drop in our later years.

Our cognitive abilities, including attention span, working memory and the ability to quickly process and integrate multiple sources of information, are all very important when making complex financial decisions. And according to the study, about half of the population between ages 80 and 89 either has dementia or a diagnosis of "cognitive impairment without dementia." The combination of declining cognitive function, years of making financial decisions, and a desire to focus on positive life experiences have resulted in a few interesting behavioral traits commonly found in older investors.

The Neuroscience Behind It All

Scientific studies like the one published in the Nature Neuroscience Journal titled "Anticipation of Monetary Gain but not Loss in Healthy Older Adults" have shown that older adults exhibit a reduced responsiveness to anticipated financial loss relative to younger adults. A portion of this subdued responsiveness may be attributed to years of experiencing the ups and downs of investing and the desire to focus on positive life experiences and not necessarily declining cognitive function. This could increase an older investor's willingness to take risk and argues against the "conservative" stereotype that most people have regarding older adults.

Other research has shown that older adults prefer not to make complex decisions themselves and that their problem-solving strategies are usually more avoidant than younger adults. This means that an older adult may be more likely to put off making important "emotionally-laden" financial decisions like estate planning, selling a concentrated investment holding or firing an inept financial advisor who also happens to be a "friend." In addition, they may be more open to seeking out professional financial advice than younger adults.

Research has also shown that, perhaps due to declines in things like cognitive control, older adults exhibit a greater familiarity bias than younger adults. Such a behavioral bias could give older adults a false sense of security when dealing with things that seem familiar. It can lead them to concentrate their investment holdings in familiar companies or assets classes, which can create a poorly diversified investment portfolio. This bias could also make them more prone to financial scams that use repetition to hook victims, like mail order fraud or the ever persistent penny stock pushing telemarketer.

The reality is that aging is inevitable. But, like most things relating to age, there are simple steps you can take to help minimize, and possibly improve, the impact aging could have on your finances.

Maintain Your Cognitive Function

The silver lining is that as you age you become wiser and declining cognitive function, not age, is what eventually robs you of your financial decision making abilities. So what can you do to maintain, or perhaps even improve, your cognitive function? According to Dr. Jeffrey Toth, a psychology professor at the University of North Carolina at Wilmington and co-author of the study "Fluency, Familiarity, Aging, and the Illusion of Truth," there are a number of ways to maintain and possibly improve your cognitive function.

"Physical exercise, mental stimulation, diet, and social interaction can all help maintain your cognitive abilities," says Dr. Toth, "and of these four, physical exercise, especially aerobic exercise, appears to be the most important, with mental stimulation a close second, especially if that stimulation is truly novel and challenging."

In addition to the positive factors listed above, Dr. Toth suggests that the avoidance of negative factors is also critical in maintaining cognitive skills. Thus, he says that "smoking, heavy drinking, a high-fat diet, and lack of sleep have all been shown to accelerate cognitive decline and thus should be done in moderation, if at all."

These suggestions have lifestyle implications for an aging "do it yourself" investor, accountant, investment advisor, banker, or anyone who wants to stay on top of their financial game well into their later years. Please keep your mind sharp for younger generations. They will need your wisdom.

Start Planning Early and Stay Organized

Start seeking out a trusted financial advisor when you are middle-aged. Make sure that the advisor will be in the business, or has a competent successor that will be in the business, when you are in your later years. Start the process of talking with family members about appointing an estate executor, keep your will updated, develop a system to keep up with your tax documents, and make plans for dividing up family heirlooms early before the negative effects of aging have a chance to set in. Precautions that will help you avoid unwanted financial solicitations should also be considered, like adding your phone number to the National Do-Not-Call Registry.

The Bottom Line

When it comes to your financial decision-making abilities, after a certain point, age could become more than just a number. The good news is that you can control what the impact of that number will be. George Burns, the famous entertainer who had a productive acting career well into his 90s, once said "You can't help getting older, but you don't have to get old." Financial education, living a healthy lifestyle, and early financial planning will help you maintain your financial wits and keep the curtains open for your greatest financial acts.

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