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- One Man's Opinions – 7/07/11 – Summer 2011

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The Impact of Aging On Financial Decision Making

I recently encountered two men in their late 70's, both of whom have done very well running their own portfolios. Each adamantly declined my recommendation to hire professional investment management for at least part of their portfolios. I was suggesting that they could monitor their managed accounts and determine if it was wise to trust the manager(s) to do a good job for their spouse and/or other heirs when they themselves reached the point at which they could no longer manage their own affairs, or they were simply no longer alive to do so. I was not, in either case, soliciting their accounts for myself and my investment managers, for to do so might have detracted from the credibility of my suggestion. I was genuinely concerned that they were going down a path which could possibly cause harm to them and/or their heirs.

To my mind, in both cases, these gentlemen are in denial of their own mortality and the effects of the aging process on our human abilities to continue to make good decisions about financial affairs. Both men have been taking more risk than I, as a 49 year veteran of the investment business, consider prudent. As of this point, though, by taking extra risks, both have, over time, outperformed the mark; both are proud of it.

The impact of the aging process on our human abilities to process information, sort out available options, and make appropriate decisions is not a positive one. We are, after all, human beings, and we all follow certain paths through this life, slowly losing some portion of our physical and mental abilities as we proceed toward our inevitable demise. For my part, I can no longer run or play racquetball at age 73.

I think it makes perfect sense for senior citizens with substantial means to interview and select one or more investment managers while they themselves are still mentally sharp, still able to judge a manager's performance, abilities, and suitability. Instead, I observe, many older investors "hang in there' until they come to the inevitable point that they no longer can effectively handle their own affairs, or they pass on and leave the problem in the hands of a spouse or other heirs who may or may not be qualified to take over these duties. All too often, in these cases, the survivors are taken advantage of by dishonest or inept people, even other family members, who prey on their ignorance.

I am all too aware of the tendency we Type A personalities have to keep control at all costs. My suggestion to these two gentlemen, and to my senior readers here, is a possible way to *continue* the control of important financial matters by finding trustworthy successors to handle the job they, the investors, have done so far.

In an article in the June issue of our professional Journal Of Financial Planning, Gregory Kasten, M.D., CFP, and his son Michael Kasten, a third year medical student, point out certain facts concerning the aging process. The article concerns seniors' decisions regarding their retirement incomes, but I believe the process is applicable to all financial affairs.

The authors point out that even physically healthy seniors experience substantial declines in cognitive function, even without clinical dementia, after peaking in middle age.

Research has shown that in a cross section of the population, the average analytical cognitive function falls by about one percent per year after the 20s. Two relatively simple calculations show the loss of analytical performance over time. Try them here if you wish. Count backward by 7s from 100 to 60. Scoring is based on a scale of one to five based on the number of correct answers. Take the test if you wish. The answers are on the next page. I got a 5, but I work with numbers all day long and was taught arithmetic by the nuns before calculators existed. The average score at age 51 is 3.2. It declines to 2.2 in one's 90's.

The second test scores the number of people correctly answering a simple question. If five people all have the winning number in a $2 million lottery, how much does each receive? The answer is also on the next page. At age 53 only 52 percent get the correct answer, at 90 only ten percent. Again, thanks to my age, 73, born before calculators, my profession, and the Benedictine nuns, I got the correct answer.

Let me point out that these age declines in our analytical function are partially offset by related increases in experience, both our own and those observed in others. ("The wise man learns from experience, the wiser man learns from the other man's experience!") Experience is sometimes also known as wisdom and the analytical factor is usually offset by the experiential figure until one reaches their 80s. Of course, those with Dementia, Alzheimer's, or other abnormal aging processes will lose this function more rapidly.
The research shows that 21% of those between 70 and 79, 53% of those between 80 and 85, and 76% of those 90 or older had at least some cognitive impairment.

Add these factors to those present to one degree or another in investors of all ages; inertia; anchoring; procrastination; framing; default choices; and the endorsement factor, and we can conclude that older people are often hard pressed to function effectively in their financial decisions. See my article "Seven Deadly Mistakes Retirees Make" below.

Ironically, older investors show a propensity to display negative attitudes toward products specifically designed to lower risk with more protection and guarantees, such as annuities. Somehow they perceive the risk that they will die prior to outliving the guarantees as a negative, even though, in the long run, we are all dead.

I urge my readers to assemble a trusted team of advisors, including a Certified Financial Planner, accountant, attorney, and qualified insurance representatives, early in your senior years while you are presumably better able to make these choices and track their contribution to you and your families' financial well being. Over time it might be wisest to turn over a major part of your investment portfolio management to professionals, who bring far less emotional distraction to your problems, are aware of your risk tolerances, and of your own particular wishes.

Q1. 100, 93, 86, 79, 72, 65
Q2. $2,000,000 divided by five is $400,000.

SEVEN DEADLY MISTAKES SENIORS MAKE AND HOW TO AVOID THEM
In 49 years as a financial advisor I have noted a number of errors often made by we "senior citizens." I list them in the order I most frequently encounter them.

1.) Procrastination. Most people fail to organize their financial affairs before it is too late to take advantage of available preferred options. This applies to retirement and estate planning, as well as insuring r isks and determining investment options and allocations. If you have not already done these, today is a good day to begin. If you have, then today is the day to review them in light of any financial, economic, tax, legal and/or family changes in your life.

2.) Making financial decisions on the basis of misinformation, or unreliable or inaccurate information. A large part this comes from listening to or seeking advice from inappropriate friends and relatives. The American public school system does a very poor job educating students in financial matters. Most high school graduates do not know even how to balance a checkbook. People often turn to equally ignorant others who have no clue what they are talking about. A good example of this is Bill O'Reilly of Fox News, with an MBA from Harvard, who once demonstrated his complete ignorance as to how international oil and gas markets work. He thinks the huge oil companies can

manipulate the price of oil and gasoline. If this allegation is true, then they sure did a lousy job from 1981 to 2003 when oil prices, adjusted for inflation, steadily declined back to 1973 levels. If ever there was a case of supply and demand working in a capitalistic system, this is it! As the result of a significant decrease in supply due to the loss of 30% of refining capacity in the 2005 Gulf hurricanes, the price of gasoline spiked sharply to well over $3 per gallon and the news was full of this "awful" situation. In six weeks the refineries got back on line and gas was $2.10. The market worked exactly as it is supposed to. Supply suddenly dropped, so the price jumped to the level necessary to restrict demand and match up with the available supply. The capitalistic system of supply and demand worked as it should.

3.) Failure to match ones goals with the correct financial instruments. I see this most in certificates of deposit where investors load up a high percentage of their net worth in these inflexible and relatively low paying taxable instruments which offer NO inflation protection. Depending on your tax bracket, there is nothing wrong with putting your emergency reserves or interim cash in CDs, but they are not particularly attractive beyond these uses. With inflation historically at three percent, a taxable four percent CD guarantees a loss in an individual account! Other risks include investment allocation and diversification, market fluctuations, and liquidity of one's entire portfolio. Are your risks in keeping with your personality and are you comfortable taking these risks? Do you even know them?

4.) Failure to minimize costs, fees, and taxes in order to keep more of your money. In today's financial world there are many options available to do this. Are you familiar with the following five tax efficient personal tax methods? Do you use retirement accounts and/or annuities to defer your income? Did you know you can divert taxable income to your children and grandchildren? Are you converting some investment income to tax free municipal bonds? Or are you using qualified retirement plans or oil and gas inve stments or real estate to lower taxable income? Are you reducing your tax liabilities with tax credits? Also, to lower expenses, do you use discount stock brokerage commissions and free accounts; index and exchange traded funds; money market funds; or professional money management in place of mutual funds in larger accounts? If you are withdrawing money from your retirement accounts, are you doing so in an appropriate manner considering taxes owed and the tax impact of these withdrawals on your Social Security? Lastly, do you have a Living Trust to save your heirs 4-10% in probate and other estate costs at your death?

5.) Failure to own your assets in the correct form to protect them. Living trusts, irrevocable trusts, credit protection trusts, annuities, and most retirement accounts can usually be protected from creditors. In contrast, property held jointly with children or others exposes both parties to the creditors of the other.

6.) Failing to prepare for the possibility of the need for extended health care. This is often overlooked until it is too late, either because of failing health or premiums being too expensive later in life. Close attention to this possibility in one's fifties or sixties is appropriate. Do you know your own choices when it comes to long term care? Can you afford to self insure, and are you willing to use your existing assets and income to do so? Is any existing coverage inadequate or outdated? Do you know and have you taken the steps to protect your assets if Medicaid is an option?

7.) Failure to protect assets from unforeseen risks. These risks include health, personal and property liability, litigation, business failures, interest rates, investments, and inflation. Insurance exists to cover nearly all eventualities. Credit protection trusts and other available options also can be utilized where needed.

Awareness of a problem is the first step needed in order to correct it. I trust these cautions will be helpful to my readers in their financial affairs.

Tom McAllister, CFPtm

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