

## David Laibson on the Hidden Challenges of Aging Clients

By Dan Richards  
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*David Laibson is an award-winning professor of economics at Harvard University, where he has taught since 1994. His research focuses on macroeconomics, behavioral economics and neuroeconomics.*



*Dan Richards interviewed Professor Laibson at the American Economic Association conference in early January.*

*A video of this interview is available [here](#).*

**You've written a paper with a memorable title, *Hundred Dollar Bills on Sidewalks*. What was the idea behind this paper?**

The most basic idea in economics is that people pick up those unclaimed hundred dollar bills on the ground in front of them. But we found in US retirement savings plans that about half the potential picker-uppers of those bills weren't doing so.

Let's say you're over age 59-and-a-half. In the US you can put money in to a 401(k) plan and the money gets matched. Then you can take the money out the next day with no penalty. This is a special opportunity only available to individuals of that age. They have absolutely no excuse for not contributing to the 401(k) plan and getting the full match.

And yet half the time it didn't happen.

**Why do you think that is? Is it because people aren't aware of their choices and should be educated.**

We educated them. We tried. But I was very naïve back then. I'm probably still pretty naïve. I thought if I just explained these rules to them, they would all immediately get it and do the right thing. We paid them \$50 to complete a three-page worksheet and calculate how much money they were losing. Along the way, we explained to them exactly how it works: Put the money in and it's matched, and then you can have it back whenever you need it.

Behavior basically didn't change it all.

We think there's a combination of procrastination, laziness, confusion, lack of trust, and a sense that every penny is needed right now, all of which jointly contribute to the sense among many people that they just aren't able to do a little better than they're doing.



### **What do you suggest is the solution?**

Even though matches are not a very strong force for driving people to save, unfortunately in the US, matching contributions have been a big ingredient in our retirement savings system. We now know what works a lot better: automatic enrollment.

Encouraging people to save with matching contributions leaves a lot of people in the cold, because they just don't take advantage of it. They don't save and are not responsive. It is better to automatically enroll employees. Only 5% opt out of the plan. This is much more effective, and, frankly, from the perspective of the firm, much less expensive.

### **I believe your argument here relates to your research on something in the academic lexicon called hyperbolic discounting. Let's first of all define what that is.**

At its core, it is the idea that we really like to have good stuff right now and postpone the hard stuff until tomorrow. We want our gratification instantly.

### **What are some of the implications of hyperbolic discounting when it comes to investor behavior?**

There's a lot of procrastination if we want to have fun today and we want to do the hard work tomorrow. Today I'm going to watch TV; I'm going to watch the game; I'm going to relax. Tomorrow I'm going to rebalance my portfolio; I'm going to call my attorney and get my estate planned; I'm going to join my savings plan at work.

Of course, there is a tension there. If I'm perpetually saying today I want to relax, and tomorrow I'm going to do my financial planning, it's always today. The financial planning keeps getting pushed off.

### **That's a reality of human nature. You could say there are two outcomes: One of them is to try to change behavior or put strategies in place so that tendency to go with the flow works for people rather than against them.**

Exactly. So, change the environment. If people procrastinate, make the status quo good behavior and leave it to them to opt out.

### **We're talking about default decision-making.**

Yes. Let's make enrollment in a workplace savings plan the default, and make that the thing that happens automatically, and if you don't like it, opt out.

Now procrastination keeps you saving. There are lots of ways we can change the environment to nudge people, in the words of Sunstein and Thaler, "towards good



behavior.” Not by talking them into being a different kind of person – we aren’t going to change human nature – but by changing the choice architecture, by changing the ways they make decisions, we can end up with a much greater frequency of good outcomes.

**You talked about default decision-making that would leave people better off if they did nothing. Are there other examples of default decision-making to consider?**

People are postponing hard work until tomorrow, because who wants to spend two hours enrolling in a financial savings plan? What would happen if we made enrollment in a financial savings plan not two hours of misery, but ten seconds. I mail you a postcard that says check this box and drop it in the mail and you’re enrolled. Now there’s no reason to procrastinate because enrollment has become an almost immediately gratifying opportunity.

**Would automatic rebalancing be another example?**

Absolutely. I’ll give you another example – deadlines. We humans work very well with deadlines. When was the last time you finished a major project well before a deadline? It doesn’t happen.

If we give people deadlines for making financial choices, then they’ll make the decision. But if we leave it open-ended, they’ll never get around to it.

Some firms say, “Welcome to our company. Enrolling in the savings plan is too important to leave this to your initiative. We have a deadline. You have to tell us within 30 days whether or not you want to enroll. You can change your mind later, but within 30 days you’ve got to do the paperwork.”

Of course, when people do the paperwork, they enroll. That’s another great way of getting people to do the right thing.

You can do that with enrolling in a savings plan, picking a contribution rate, or asset allocation. There are lots of activities where a deadline gets people to focus, and almost invariably they make the right choice.

**Let’s change gears here. You and some co-authors received an award for a paper that you wrote last year, *The Age of Reason: Financial Decision-Making over Investors’ Life Cycles with Implications for Regulation*. Where did the idea for that paper come from?**

We noticed an interesting pattern in our data: Individuals who were middle-aged got the best deals in credit markets – the lowest interest rates. They paid the lowest fees. And individuals that were younger and older seemed to be making mistakes. They were not negotiating successfully. They were paying higher interest rates on their mortgages. They



were paying more fees with their credit cards. They were paying higher credit card interest rates.

This pattern was very, very strong. We controlled for things like their FICO score, their credit rating, and the loan-to-value ratio on their mortgages. No matter what we controlled for, the same pattern kept appearing.

We eventually wrote a paper about it. We looked at 10 different markets, and in every market we saw the same pattern: Younger and older adults don't do so well in these markets. Middle-aged adults seem to be at the peak.

### **How do you define middle-aged?**

We let the data tell us what was the peak performance. It turned out 53 was the peak, which is not to say that 54 was all that different, but if you think about a kind of bell-shaped curve, 53 was at the very peak of that hill.

There are lots of reasons to expect that younger. For example, younger adults don't have that much experience. They don't have a lot of knowledge about financial markets. They don't have four mortgages. So this is their first time.

### **Perhaps they're not strong negotiators.**

They are not experienced or knowledgeable, so it might be negotiation is a big piece of it. It may also be that they don't understand you've got to shop around for a mortgage. You've got to go to three or four banks and play them off against each other. Eventually you figure that out.

Older adults were a much more interesting story. We looked at evidence of cognitive decline in other people's work, and we gathered some of our own evidence. There is a remarkable pattern whereby fluid intelligence – people's ability to confront a new problem and figure it out – basically declines after age 20. It declines very steadily over one's life.

As we get older, we gain experience. There is a war between rising experience, which makes us better financially, and declining fluid intelligence, which reduces our ability to do well. For older adults, the experience factor doesn't make much of an additional difference. They are tapped out of experience, and their decline in fluid intelligence keeps reducing performance. For individuals in their 70s and 80s, their decisions are being compromised.

There are two other ingredients I want to emphasize. First is dementia. Between age 80 and 90, about half the population has a diagnosis of full-blown dementia or cognitive impairment without dementia, which means they're on the doorstep of a diagnosis of dementia. So they are very, very vulnerable at that age.



The second important thing to remember is that population has a lot of wealth on hand. They've been saving their entire lives. So there's a lot of vulnerability, because of cognitive decline and because they're sitting with that pot of gold, which we should hope they're going to spend over the rest of their lives. Instead it's vulnerable to bad choices and fraud.

**The second part of the title of your paper is “implications for regulation.” What things did you and your co-authors believe need to be considered from a regulatory perspective?**

We don't think there any answers yet. There's a lot of reason to be concerned, and we threw out some possibilities. So I'll throw them out to you as well.

One thing that we might think of doing is creating a safety zone – assets that are in some sense recommended for older adults. They might have low fees. Maybe they are annuities. We might actually push people to live inside that safety zone, where it's very easy to do the right thing and it's hard to get ripped off. If people want to exit that zone, that's a decision that they can make, but maybe we should create a few hurdles so that they don't exit it in a moment of impulse without thinking hard about that decision. The person offering them a product that's outside the safety zone might have to get vetted, or there might be someone else who would have to sign off and say, “Yes, this is okay.”

Another possibility is encouraging people to leave their money in their 401(k)s or their retirement accounts. Those tend to be pretty safe environments with a fiduciary who oversees the plan. The plan sponsor usually plays the fiduciary role, and there, too, it's hard to get ripped off.

There are lots of ways to create a more protective environment for older adults, and we offered lots of ideas and suggestions about how we should begin to think about the solutions, though at this point we don't have any answers.

**Can you summarize the age at which dementia starts to happen in a meaningful way?**

The pattern is very systematic. The prevalence of dementia doubles every five years. In the early 60s, it's very low, but then it doubles every five years. By the time you get to your 80s, about half the population has some form of significant cognitive impairment.

If you are thinking about financial planning, you really want to make substantial progress before age 70, because there's a real risk that in the 70s, and particularly in the 80s, the individual will have passed the point where they're completely cogent.



**Should people consider putting in some default choices that automatically kick in when they hit age 70 or 80, to ensure appropriate changes to their portfolios?**

Absolutely. They could invest in a life-cycle fund that would do all of that automatically, or ask a financial planner to do that for them. In many ways, an annuity is the ultimate way of pre-committing to some automatic system. You get the check every month until you die. There's nothing that's asked of you, no rebalancing, no decision-making. So an irreversible annuity is a great way to commit yourself to financial sanity, whether or not you have cognitive function late in life.

**One of the issues that financial advisors struggle with is whether a client is suffering some cognitive decline. It's a very difficult issue at that point to start involving other members of the family, because there are issues of confidentiality and privacy. Are there considerations that financial advisors should bear in mind in those situations?**

At that point, it's really too late. You are right; the confidentiality makes it very difficult. One needs to be supportive, and one needs as much as possible to bring other family members in when appropriate. That means frequently asking whether other family members should be involved, and hoping for the answer yes. Even if the answer is no, eventually, hopefully, there will be a "yes moment" without pestering the client.

**The other solution is raising that, not in an intrusive fashion, but in an appropriate fashion as people are in their mid- or late 60s.**

Why wait until then? You can set up an estate plan at any point, and, in fact, as soon as a client has a family, that's the moment to set up an estate plan, to choose trustees, and to set up all of the mechanisms. It's much less threatening at that point, because an individual in their 40s or 50s obviously isn't thinking that their control is about to be taken away. The earlier, the better, and gaining familiarity with these issues at a young age helps the conversation at the later age.

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