Decline in cognitive ability leads to fear of upfront costs

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In 2014, 75.4 million Baby Boomers lived in the United States, according to Pew Research. As this generation continues to age, dialogue will increase on how to manage concerns associated with aging, such as the decline in cognitive ability and retirement decisions. Now, a researcher at the University of Missouri has found that older individuals with lower cognitive abilities are susceptible to behavioral biases, such as being adverse to upfront costs. Michael Guillemette, an assistant professor of personal financial planning in the University of Missouri's College of Human Environmental Sciences, says that risk aversion, along with lower cognitive ability among older Americans, might explain the lack of demand for certain retirement savings products.

"Some financial products, such as annuities, have upfront costs," Guillemette said. "With a pure-life annuity, an individual will pay an upfront cost that is typically $50,000 or higher and in exchange will receive monthly payments for life. The risk associated with annuities comes from the uncertainty of death. If the full amount of the annuity is not paid out prior to the death of the recipient, the money is lost. In our study, an upfront cost caused people with lower cognitive abilities to shy away from future risky decisions."

In the study, Guillemette and his coauthors Chris Browning and Patrick Payne from Texas Tech University, measured participants' cognitive function by evaluating respondents' working memory and numeracy. The analysis considered two hypothetical risky financial prospects, both with equivalent expected returns, but one situation included an upfront cost

and the other had no upfront cost.

Results from the study show that individuals with lower cognitive ability exposed to the perceived upfront cost were less willing to take subsequent risk. Results from the study might help explain the low demand for annuity products among older Americans. The results might also explain why companies choose to break up upfront costs in order to increase sales. For example, a large phone company now has a program where you pay for the full cost of the phone over several years.

Baby Boomers, on average, have insufficient retirement assets, and a strain on the Social Security System leaves questions for how this generation will support themselves as they age. Annuities can play an important role for older Americans. Serving as a type of insurance, annuities can help protect people from running out of money before death. However, results from this study reveal that the upfront cost associated with annuities might deter older individuals from purchasing these products. Guillemette says that the industry could improve the demand for annuities by breaking the large upfront cost into incremental payments over time. The researchers also say that financial advisors often describe annuity products as investments, but they might be more appropriately framed as insurance products that protect against loss.

"The perfect storm is created as individuals age," Guillemette said. "When they get into their 60s and, especially, 70s it is natural to experience cognitive decline. This becomes detrimental when combined with the fact that as individuals age, they also become more confident in their choices. A Certified Financial Planner who is a fiduciary could be beneficial because he or she could recognize those cognitive shortfalls and work in the individual's best interest in terms of proper financial decisions."

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