UBS

Modern retirement monthly

Retirement is a family affair | 7 February 2018

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- Cognitive decline and failure to make planning a family affair are risks that can ruin even well-crafted retirement plans.
- Longevity risk and cognitive impairment are realities related to our health that we need to face as we age.
- Most families lose their fortune by the third generation – a phenomenon that may partly be explained by a weak foundation of family values.
- The risk to retirement planning can be preempted by something that is completely within our control: communicating our plan with our loved ones.

"What we've got here is failure to communicate"

Investors put in significant amounts of time and thought when it comes to financial planning and retirement readiness. But while preparing for retirement can add a level of certainty and reduce stress related to lifestyle change and navigating the next chapter of our lives, too often our plans can be ruined by a simple inability to make them known to those that matter the most and for whom we are planning in the first place: our families.

The line quoted above is from the prison movie "Cool Hand Luke," but it's something that has probably been said many times during family meetings. Indeed, conflicts around wealth are an all-too-familiar plot in many Hollywood dramas. However, has it ever occurred to you that you won't be able to retire "your way" because your family never heard about your goals, hopes, and wishes? Or that your intergenerational wealth transfer will fail because you did not share your intentions with your children and grandchildren, or perhaps even your spouse? Or that, in the future, due to cognitive decline or the onset of an aging-related mental illness, you end up changing your carefully laid-out plan to your own and your family's disadvantage? Not only do investors have to think about saving for retirement, investing appropriately, and spending wisely; they also need to plan and communicate better.

In this edition of Modern Retirement Monthly, we discuss two specific risks that can ruin even the very well-crafted of retirement plans: cognitive decline and failure to make planning a family affair. Longevity risk and cognitive impairment are realities related to our health that we need to face as we age, since they could lead to financial fallout.

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Likewise, several studies have shown that nine out of 10 affluent families lose their fortune by the third generation – a phenomenon that may partly be explained by a weak foundation of family values. In both cases, the risk to retirement planning can be preempted by something that is completely within our control: communicating our plan with our loved ones. This includes sharing not only financial decisions with those you trust, but also taking the time to discuss family values and your personal wishes.

Longevity and financial decision-making

Financial planning and insurance policies are there generally to help people ensure that they have enough financial resources to last them 20 or 30 years in retirement, avoid becoming a burden to their family, and increase the likelihood of achieving their goals. However, many individuals forget to consider, until it's too late, that they might not have the ability to manage their finances in the future.

Our optimism bias, which allows us to take risks and try new things in life, also becomes a challenge as it makes it difficult for us to envision ourselves as increasingly frail seniors. In other words, we unintentionally paint our future based on our often positive outlook, and make decisions based on this vision rather than based on all possible futures that might unveil.

Consider the following example. On average, a man and a woman who are 65 years old today can expect to live to 84 and 86 years of age, respectively – six years longer than the respective average life expectancy in 1950. One out of four individuals will live past the age of 90. In addition, individuals are retiring earlier, which means they have many more years to spend in retirement than ever before. While life expectancy has been steadily increasing, many individuals choose to keep their saved lump sum instead of opting for a fairly priced guaranteed income stream that we generally tend to like (e.g. Social Security). From a rational point of view for many investors, annuities provide a good hedge for "longevity risk" as it addresses the risk of outliving one's income, and it deals with other complex issues such as when to retire and how much to spend in retirement. Nevertheless, some individuals seem to ignore the longevity risk and incorrectly forecast that they will not reach a "breakeven" point, which partly explains why too few retirees annuitize their retirement assets – a phenomenon known as annuity puzzle.

The reality is that our cognitive ability – our capability to integrate and process new information – starts to decline when we're as young as 30 years old. Unfortunately, in a household, families often split their roles; and to financial novices who end up outliving their spouse, this is especially of concern. Due to normal cognitive aging, these retirees will need assistance making financial decisions because for them the learning curve will be a big obstacle to tackle. It is invaluable to have trusted family members or friends around to prevent retirees from making any serious mistakes, including spending all of their resources.

Who will manage your finances if you're unable?

Many individuals forget to consider, until its too late, that they may be unable to manage their finances in the future.

In need of financial assistance

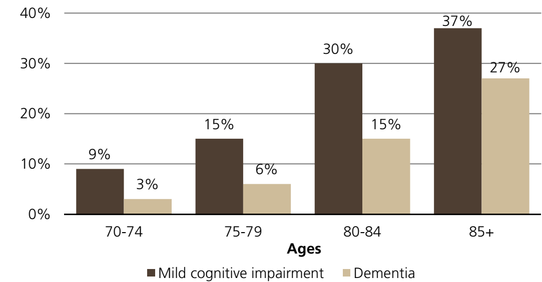
Families often split their roles within households, and to financial novices who end up outliving their spouse, this is especially of concern.

Risk 1: Cognitive impairment

As highlighted in one of our Behavioral Finance Series podcasts, sometimes even when we plan for our future selves to be protected from physical and cognitive decline, things don't always turn out as we anticipate. In the podcast episode with Terry Odean, a professor of finance at UC Berkeley's Haas Business School, he gives the example of his father, who had the foresight to take out a long-term care policy. Many years later, while on vacation, he stepped on a curb, hit his head, and suffered a concussion. As a result of this accident, he canceled the policy, which he had had for 20 years, when he needed it most. When his ability to make a sound financial decision started to slip, he had nobody to check in with to ensure decision quality.

The severity of mental state decline can range from mild cognitive impairment (MCI) to dementia. According to a recent study, of individuals in the early 70s, 9% have some form of impairment and 3% have dementia. As individuals get older, the likelihood of cognitive impairment increases very rapidly, and 37% of those who are over 85 years of age have MCI and about a third have dementia (see Fig. 1). [1]

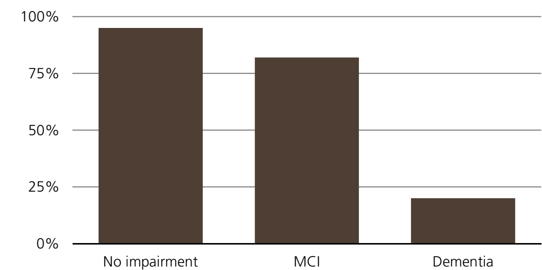
Fig. 1: Incidence of mild cognitive impairment and dementia by age



Source: Belbase, A. and Sanzenbacher, G. T. 2017. Cognitive aging and the capacity to manage money. Center for retirement research at Boston College.

Fig. 2 shows the percentage of adults who are able to manage their personal finances based on impairment status. Many seniors with natural cognitive aging are able to perform routine tasks such as paying bills, and they continue to understand financial concepts. However, those with MCI are likely to need help with more complex or unfamiliar tasks. Adults with dementia will require help even with basic financial tasks. It is important to note that, too often, individuals don't realize that they have cognitive impairment and continue to feel confident about personal finance. Therefore, they are more likely to be targets for investment scams and other fraudulent schemes. Even their caregivers can take advantage of them since their impairment may make them feel confident about their ability to make financial decisions.

Fig. 2: Percentage of adults capable of managing their finances, by impairment status



Source: Belbase, A. and Sanzenbacher, G. T. 2017. Cognitive aging and the capacity to manage money. Center for retirement research at Boston College.

Risk 2: Keeping your plans to yourself

In many families, individuals build a plan with their advisor and limit their discussion with the children to topics like vacations, thus avoiding the needed in-depth conversation with the children about net worth, long-term care, where they wish to live in retirement, as well as issues related to inheritance, wills, and family values. In case something happens to parents, the children are suddenly faced with who gets what for the first time. Then the children each go to their separate advisors and try to familiarize themselves with the plan and somehow implement it. In other words, no one who was involved in building the plan is involved in executing it, and each person potentially has conflicting interests.

For many families, lack of communication is a crucial obstacle to overcome. Research indicates that among high net worth families, money and health are two of the top five taboo topics on the list.[2] Too often, there are no discussions as a family about hopes, dreams, healthcare, insurance, or money because these tend to be emotionally difficult topics. As a result, although many families take the time to update their wills and create financial plans, these often don't go as intend-

ed. In fact, research indicated that as much as 70% of intergenerational wealth transfers fail.[3] The main reasons for failure boil down to a lack of communication within the family: lack of family mission (12%), inadequate preparation of heirs (25%), and a breakdown of family communication (60%). Only 3% failed due to bad advice.

The results of our own UBS Investor Watch survey indicate that 83% of the respondents had an updated will, while only half had discussed plans with their children and 34% had shared with them how much wealth they have (see Fig. 3). In other words, the reason for failure is completely in families' control.

Best practices

1. Talk to the family
To improve the outcomes of your financial plan, it is crucial to talk about insurance and to share financial decisions with your spouse. It is invaluable to have a trusted family member who can make decisions on your behalf. They should be aware of all your accounts, records as well as your goals and values. If these plans aren't communicated, there is no one to ensure sound decision-making. In addition, in case a novice is left to make a decision, that individual will have a hard time learning from scratch.

2. Talk to a trusted advisor
Having someone who knows you and your financial plan can provide you protection from your future self and can ensure that the family values are communicated and preserved over time.

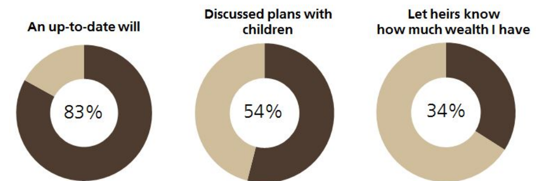
3. Initiate the discussion
When it comes to overcoming challenges related to inheritance plan discussions, both parents and children prefer that the parents initiate the dialog; very few believe the children should do so (see Fig. 4). Ultimately, it's the parents' wealth and they should play a significant role in determining its impact on the lives of others.

4. Nominate the alpha child
Know who the "alpha child" is and get them involved. This is the one family member that should meet your financial advisor. Make sure your children have access to a list of the names and numbers of all of your legal, tax, insurance, employer, and financial contacts.

5. Build family values
Family discussions on retirement planning don't have to be limited to trusts and tax strategies; they can include conversations about family values, and how to get the whole family involved to make an impact, now and after you're gone. That can be a very interesting, and exciting discussion.

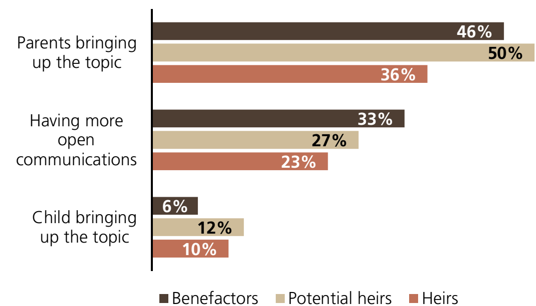
Procrastination makes it too easy to put difficult things off for tomorrow. Start planning and communicating now so you don't have to worry later, when it's too late.

Fig. 3: One of the top things adults don't discuss with their children is money
Which of the following have you done?



Source: UBS Investor Watch 3Q2014 Begin before the end, p. 4

Fig. 4: Majority agree that benefactors must be the initiators



Source: UBS investor Watch 3Q2014 Begin before the end, p.4

End notes:

1. Belbase, A. and Sanzenbacher, G. T. 2017. Cognitive aging and the capacity to manage money. Center for retirement research at Boston College.
2. deVere Group conducted an international survey of 830 high net worth clients. Results can be found here: https://www.devere-group.com/news/Money-conversation-taboo.aspx
3. Crossed wires: Why most generational wealth transfers fail, Scott Clemons, Women & Wealth Magazine, 2016; provided by Brown Brothers Harriman & Co.

Appendix

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