

White Paper
Financial Literacy and the Life Cycle

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by

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The U.S. Financial Literacy and Education Commission defines financial literacy as “the ability to make informed judgments and to take effective actions regarding the current and future use and management of money.” Financial literacy should include the ability to understand financial choices, plan for the future, spend wisely and manage and be ready for life events such as job loss or saving for retirement. At the heart of the definition of financial literacy, is the term “informed,” as emphasized previously. It is the effective use of information in the decision making process that separates the more literate from the less literate decision. This paper will focus on what constitutes information as defined, what are the benefits of being informed, the costs of not being adequately informed, and the dynamics of information over time.

As with any other decision, a financial decision arises from some need. The study of the nature and characteristics of various financial needs serves as the starting point in financial education. As will be seen in the rest of the paper, the understanding of financial needs leads to an understanding that there exists a structure of reasoning and explanations, which is both necessary and sufficient to understand the crux of the issues regarding financial literacy at various stages of life. In considering the entire process of education, a very useful analogy can be made between the financial health and well-being of a person and their medical health and well-being. Regarding medical health, it is infeasible to educate all consumers about how to take care of all their medical needs. Rather, the general education regarding health is mostly in the lines of educating about activities and behavior, such as good diet and exercise, which generally promote good health and well being. Further, people seek expert medical help when they observe symptoms of problems in themselves. Similarly, the intent of financial education should concentrate on financial activities and behavior that promote general financial well-being and health. Along the same lines, the general education should also provide consumers with the ability to detect symptoms of poor financial health so that they can seek a financial expert. Thus, financial literacy must begin by explaining the need and importance of good financial decisions.

Individuals make a wide array of financial decisions through their lifetime. Examples of such decisions include saving for retirement, managing credit wisely, budgeting, tax and estate planning, insurance etc. Each of these decisions is prompted by the emergence of a need. To help consumers make informed decisions, the process of education should begin by a very clear explanation of the need and *why* the decision to correctly satisfy the need is so important. This explanation should also be accompanied by the costs of an ill-informed decision. In the rest of the paper, three examples of financial decisions will be continually used to elaborate on the content and process of literacy. The reader is urged to apply the philosophy exposed through the dissection of these examples to other financial decisions and conclude whether the knowledge can be generalized for all financial decisions.

Consider first the example of saving for retirement. In this example, the consideration begins by observing that the primary objective in this decision is to save so that the standard of living established by the individual prior to retirement can be maintained through the retirement years. The pinpoint accuracy of the explanation is important because it serves as a way to avoid complications with other potentially related decisions, leading to less-informed decisions. While most consumers understand that retirement implies the cessation of work-related income, they may often fail to appreciate that the retirement years coincide with the gradual loss of an ability to make up for shortfalls in retirement funds with advancing age. It is this knowledge that can truly spur the decision to save. In an equivalent sense, the consumer needs to understand that the cost of not having sufficient funds during retirement when the funds are most needed can result in reductions in living standards that are more painful at an advanced age. The clarity is also important to separate other decisions that are often included in this decision. For example, consumers budgeting for retirement savings may include the contributions made in funding children’s college education. Consumers need to understand that this is a separate investment and savings decision and should be approached separately. Otherwise, the simultaneous solution of attempting to meet two different financial objectives will typically lead to sub-optimal decisions and transactions in unsuitable products. This latter example exposes the role of clarity in defining financial objectives. In turn, it is this clarity that leads to the proper “informed” decisions.

As a second example, consider the common need for life insurance. In this case, the primary information is that this need allows the insured person the ability to protect her/his dependents and loved ones from a sudden loss of income due to a premature and unexpected death. Thus, life insurance is said to cover “pure” risk. This explanation is easy for most consumers to comprehend. This clarity is a necessary piece of information since life insurance products are commonly bundled with instruments that satisfy other financial needs such as investment, tax deferral, small business succession, or as a source of credit. Without the definitional clarity, the decision becomes complex since the various bundled instruments may indeed be the most suitable and optimal instrument for some consumers. Generally, understanding this suitability issue is beyond the grasp of most consumers. In a sense, educating consumers about the basic need in this case may just prove to provide a preventive rather than a curative set of knowledge. A third and final example is now considered. When a consumer saves to buy a house, it is because she/he wishes to provide a secure and comforting environment for her/his family. This reason is generally well understood by consumers. Unfortunately, what is not understood is that the satisfaction of this primary need may be jeopardized if the decision includes elements that solve other financial needs. For example, most consumers understand that an owned house is also an investment vehicle and for this purpose is more desirable than the alternative of renting a home. However, as in many other decisions, the decision to invest in real estate is also speculative. It is quite clear that a part of the education process should include that making a decision based on satisfying more than one need at a time for some consumers may be a symptom of potential financial loss and/or the loss of peace of mind. Similarly, equity in real estate is also a source of credit, and again, in this case, a secondary need. Consequences of mismanaging this and the primary decision can and does lead to similar undesirable outcomes.

The above three examples of common financial decisions illustrate first and foremost the importance of crystallizing the basic needs in the minds of consumers. This in turn should lead to a set of information that consumers will need to make informed decisions. Thus, it can be said that the first step in financial literacy is the clarification, in all details, of the financial objectives for the decision being made. It is also important to educate consumers to determine when to make a financial decision on their own, and to understand symptomatic conditions of deeper rooted problems that may require financial expertise from an independent, qualified adviser. In other words, consumers should be educated in the need for financial literacy and education. Such educated consumers benefit most from education, counseling and guidance, public and/or private.

The next step in the literacy process is to help consumers learn about the need to prioritize the objectives and the methods of doing so. To begin with, consumers have a wide array of financial needs and a limited amount of resources. Hence, there exists a need to allocate these resources in the most efficient and optimal manner. A comprehension of the need for efficient allocation should then be followed by an education process of the order and magnitude in which various financial needs should be addressed. To do so, the first step is for the consumer to understand the time horizon of each of the decisions. Using the three examples in the previous section, the need to understand the implications of time horizons can now be duly explored.

Generally, the need to make financial decisions begins with an individual’s work life and career. In other words, the need to decide on cash outflows begins when cash inflows begin. For most individuals, this generally happens during their early 20s. Consider the typical needs of such a person. The new found economic identity most often leads to greater consumption, especially those purchasing preferences that were postponed due to a lack of resources. Further, it is often during these years when such people begin thinking about raising a family. One of the first financial decisions that many individuals make at this stage is to begin saving towards the objective of purchasing a house. This decision is also made easy by the fact that the outcome of this decision is of a shorter term and young professionals are more comfortable with that perspective. To many people at this life stage, the need to insure her/his life is not of a high enough priority, since this person typically does not have any dependents as of yet. Similarly, the need to save for retirement, an event more than 40 years away, is generally an even more remote objective.

Educating this person on the need to allocate some of the income for insurance and retirement savings needs is not only about financial education but it is also about life counseling and planning. Two things must happen for this individual at this point. First, the individual must be counseled strongly about why savings for retirement is so vital for individuals in their early 20s, especially when mortality and old age may not seem immediately relevant as a financial objective. However, the difficulty here is alleviated through financial literacy, i.e., an appreciation that this individual can actually set aside a very small sum and that the power of compounding and a lengthy investment time horizon will do the rest. Thus the educator should be able to demonstrate that the loss in consumption diverted to a savings plan is very small. The case for purchasing life insurance is similar but its illustration is more powerful in the context that follows next.

Now consider the individual in our example 10 years later, or in her/his 30s. Typically, this individual is married and may have a child (or children), earning more and having accumulated a certain sum of money towards the purchase of a home. The most powerful need for this individual is to protect her/his dependents in the event of a parent's premature death where the dependents lose their source of sustenance. Most individuals purchase some form of life insurance at this point. Herein lies the core of the educational concept. Recall the primary objective of the decision. Given that, the individual must understand that the protection being afforded should exist as long as their career and related incomes require a substitute, contingent income. In other words, the primary objective of managing this pure risk is of a finite term, i.e. the rest of their *working* life. Hence the instrument they purchase should be for this duration as well. Two factors follow from this observation. First, for many people in low to moderate income categories, purchasing a term life insurance policy is all that is needed. However, what they are frequently exposed to is the existence of products which protect in the event of untimely death but which are bundled with other investment, credit and tax deferral instruments, instruments that serve different financial needs. What such customers should understand is that separating the two decisions of risk management and other financial needs management can actually lead to greater consumption and costs. Unfortunately, the fear of premature death often clouds consumer judgments, leading to the purchase of unsuitable products. Hence, it is observed that the clarity of the objective and the life stage are intricately connected with making suitable product choices. **Note:** The corollary that individuals in higher income categories may receive the benefit of different types of whole life insurance products that generate a cash buildup for retirement may well be true.

Second, the consumer in his/her 20s should be knowledgeable of the fact that they will most likely buy a life insurance product when starting a family and that buying it today can actually save them money due to much lower premiums over time. Similar to retirement planning, awareness that the individual will need to insure at some time along with the knowledge that lower premiums for younger individuals will actually optimize their current consumption and not reduce it, is similarly necessary and beneficial.

Proceeding along the age line, individuals in their 40s generally earn more than before and many at this point have also purchased a house. The financial needs at this stage and their priorities have now changed. Whereas retirement was a distant concept in their 20s, it is not abstract today and its priority has increased considerably. Hence, one at this stage in life is more willing to accept the need to save for retirement, if the individual is educated properly. By this time, such educated individuals should also be able to have foreseen the rise of new needs such as saving for children's education or minimizing their tax liability, etc. By the time this individual is in his/her 50s and at the career peak and wage earning power, they should be comfortable in the security of the financial decisions they have made so far. An important observation regarding the changes in decisions during the aging process is that speculative financial decisions, if made, are much easier to contend with at the early career stage than at the latter stages of their careers or life. In other words, the risk-taking part of financial decisions should be made more at the early stages and gradually decline over the life cycle. For example, in the early years of savings for retirement, individuals should focus on capital growth. With age, this focus should change to preservation of capital and generation of income. This issue is discussed in greater detail in the next section.

Taken together, the financial objective of a decision and the life stage help determine the priorities of the decisions. This generally should lead to the more efficient allocation of the limited resources and eventually the successful satisfaction of lifetime financial needs. There remains one last, and in a sense, the most critical step in the education process. This step helps consumers understand the suitability of financial products and ensures the optimal financial decisions.

This critical step is educating individuals about themselves, especially their perspective on risk. Central to this step is to educate consumers about the very important fact that financial decisions are the outcomes of *reasoned* processes; their decisions are not based on emotions. It is often this misunderstanding that causes difficulties and pain to many consumers. Common examples of emotions that become entangled and may strongly influence financial decisions are those of greed and fear. Decisions based on these emotions will in most cases have unsuitable outcomes. To illustrate further on the problems of emotional decisions and the benefits of reasoned decisions, the earlier financial examples can be utilized.

Consider the earlier discussion of saving for retirement. The mainstay of this decision lies in an understanding of the power of compounding. In the early career stage of an individual, the power of compounding along with the longer time frame for saving allows the usage of a very *reasonable* return expectation on savings to achieve the necessary funds for retirement. The emphasis is on the term “reasonable.” The natural question that arises is what are examples of reasonable expectation is for a young individual who is saving for retirement. In this case, an expectation of a return between 9%-12% can be thought of as reasonable. A conservative youngster may seek a 9% rate while the aggressive one may choose to earn a rate of 12%. Differences in risk tolerance, as exhibited by return expectations, will exist among people in similar career stages but the difference in expectation need not result in differences in expected returns that span a very wide range. However, when individuals are tempted by the promise of, or are exposed to stories about certain financial instruments that can provide exceedingly high returns then the glitter of these promises do sway individuals to depart from their rationality and make mistakes due to irrational expectations. In some instances, such decisions can lead to financial ruin. Reasonable expectations, along with a clear, time-bound objective is all that is required to make informed decisions, much like a disciplined regimen of diet and exercise are necessary for general good health. Further, consumers also need to be educated on the concept that these return expectations will also change as they progress through the life cycle. This return dynamic can be observed through the example of the need for capital growth in retirement savings in the earlier years of a career changing to the need to preserve the funds at the latter stages. This change in need can simply be translated as a decrease in return expectations over the life cycle. In other words individuals become more risk averse with age and seek safer financial instruments that also necessarily provide lower returns. Thus, consumers need to understand that the expectations of returns on savings should generally decrease with age.

Fear on the other hand is often portrayed as the primary consideration in purchasing life insurance, instead of the need to protect dependents. Consumers need not be afraid of premature death in purchasing life insurance. Rather, the education is for consumers to accept the positive probability of such an event as spurring the decision. Unfortunately, it is more often the fear that the well-being of loved ones may be jeopardized that prompts the purchase decision. Even more unfortunate, this fear can often lead to the purchase of a product that attempts to solve more than one need and which may not be suitable for some consumers. Underlying such complex products is the temptation of irrational return expectations. For example, many consumers in average income groups may not benefit from whole life products where the accompanying tax deferral and investment products use growth (of capital) vehicles, such as stocks, which are implicitly (capital gains) tax deferred.

Finally consider the purchase of a house. Consumers need to understand that while the equity in a house is a source of credit, borrowing against it for consumption purposes may not be a wise credit decision for some. Complexities due to the speculative nature of real estate and issues regarding the relationships between interest rates and value are often too complex for most consumers to understand. Unfortunately, the attraction of easy money can lead to an emotional decision which may ultimately defeat the very purpose of the purchase.

Thus, at the heart of financial education lies the need for consumers to understand that reason and rationality must be the only way in which financial decisions should be made. In fact, they should understand that such a disciplined approach to financial decisions generally lead to achieving the desired objectives. Thus reasoned financial decisions lead to good financial health much like what good diet and exercise does for physical health. Alternatively, unreasonable expectations – for any financial decision -- generally lead to poor financial health.