062708 Living Benefits—Are They Good or Bad
By Gary Case

A relatively new phenomenon on the investment product horizon is the concept of living benefits—either income or principal guarantees—attached to traditional investments such as mutual funds, managed account, annuities, and life insurance, and other investment products. Alternatively praised and skewered, of living benefits may be useful to people looking towards generating income from their investments.

The genesis of living benefits occurred during the bear market of 2000-2002 as people either attempting to retire or already retired saw their portfolio values decline precipitously, causing concern as to the viability of that portfolio generating a sustainable long-term cash flow. The risks even got names: "sequence of return risk" and "longevity risk." Prior to living benefits, financial planners employed techniques such as hedging portfolio risks through options and other derivatives, placing several years worth of income in a cash-like account while investing the remainder of the portfolio into diversified growth positions, and using immediate annuities to generate baseline income. Growth is often necessary in helping portfolios to produce an increasing stream of income which works to offset inflation.

Living benefits are NOT investment products, they are insurance put in place by a sponsoring company to provide the purchaser of an investment product a guarantee of some sort, based on the sponsoring company's ability to make the guarantee good. For example, one investment platform uses a guaranteed minimum withdrawal benefit as a living benefit. At the time the benefit is selected, an income equal to 5% of the account value that day is guaranteed for either a single lifetime or a joint lifetime between spouses. While the income can never go below the original amount, if the account value on any birthday of the owner is higher than the value on the date the benefit started, the new higher account value becomes the basis for future income payments. Distributions from this benefit are generally taxed as ordinary income.

An annuity company guarantees a similar lifetime income using insurance laws and a benefit known as the exclusion allowance, which allows a portion of the regular income to be returned to the income recipient free of income taxes. There are also provisions in the annuity contract for income to increase if certain conditions are met.

While there is an undeniable appeal to living benefits, there is also a cost. It is not unusual to pay 0.8% - 1.2% of portfolio value to add living benefits. Additionally, the benefits are somewhat complex and should be evaluated by the investor, their financial planner, and tax and estate advisors.

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