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WHY YOU NEED TO OWN GOLD

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If you were to travel 100 years into the future, never to return to 2010, what would you pack for the trip: $1 million in cash or $1 million in gold?

If you're like most of Northern Trust's clients, you'd pick the gold, says Bob Browne, chief investment officer for the Chicago-based high-end bank. "I would guess 99% of clients say 'I'll take the gold,'" he says, adding that gold has proved its value over and over again in the past century—in the faces of political upheaval, world wars and the debasement of currencies.

The yellow metal, which last week hit an record high of $1,275 an ounce, has been drawing a lot of attention lately from affluent investors and their advisors. Long considered an asset that only a conspiracy theorist could love, gold has suddenly become a staple in the model portfolios of private bankers and other advisors to the rich. Many experts now recommend about 5% of your assets be put in gold, chiefly as insurance against a massive financial crisis. When other assets are falling, you can count on gold to perform.

Even now gold is showing its appreciation potential, having climbed 21% since February. Little wonder some advisors are recommending allocations of a good deal more than 5%.

Felix Zulauf, head of Zulauf Asset Management in Switzerland and a member of the Barron's Roundtable, says "the percentage in gold is a very personal matter. Some feel comfortable with 5% and some with 50%." Many investors, he suggests, would do well with an allocation of about 10%.

Some big-name investors have been pushing heavily into gold. John Paulson of Paulson & Co. and Eric Mindich's Eton Park Capital Management have both snapped up millions of dollars in gold exchange-traded funds in the second quarter, according to regulatory filings. Nowadays, it seems, everyone is discovering he has at least a little bit of the inner gold bug.

Gold prices have tripled since 2004, and more recent worries about global economic health, sovereign risk, inflation and resources demand have given prices a fresh lift. These worries won't ebb soon, so gold will likely continue to gain.

Futures prices on the Comex division of the New York Mercantile Exchange first touched $1,000 an ounce in March 2008, and like all assets, fell during the initial concerns over the credit crisis, to just under $700 in October 2008. Gold swiftly rebounded, and is sitting at all-time nominal highs. (Adjusted for inflation, gold still has not matched the previous futures market high of $873 in 1980, which would be about $2,300 today).

Investors' attitudes have been changing rapidly, too. Raj Sharma, a wealth advisor with Merrill Lynch Private Banking and Investment Group in Boston, says when his firm first introduced gold as part of clients' portfolio several years ago, there was natural skepticism. But that has lessened considerably.

"It's a way to diversify, and alternative assets are always appealing to our clients because of the low correlation [with equities]. We like gold, commodities, real estate, hedge funds and private equity," he says.

Structural changes in the gold market make the asset all the more appealing. Among those: Growing demand from markets like China and India, greater money supply as governments try to stimulate their economies, and the rise of gold ETFs, which make it a snap to invest in gold.

In a nutshell, gold ETFs are easy to trade and eliminate the storage and security worries that come with physical gold. Most track gold prices without the owner ever touching the metal.

Paul Justice, director of North American ETF research at Morningstar, prefers ETFs backed by gold to those backed by futures contracts and other derivatives, because collateral eliminates credit risk. His favorites include the largest and oldest physically backed gold ETF, the SPDR Gold Trust (ticker: GLD), which has $51 billion under management, and iShares Gold Trust (IAU), which has $3.96 billion under management, because they are highly liquid.

Some money managers, though, advocate physical gold, especially if one is concerned about how ETFs would perform in a crisis. Zulauf and Marc Faber, who is editor and publisher of The Gloom, Boom & Doom Report and also a Barron's Roundtable member, both feel strongly about owning the actual metal in the form of both bars and coins.

Physical gold can be bought at banks and reputable dealers. Be sure to get investment-grade coins; not all coins qualify.

Faber says he owns kilo bars and coins, mostly Krugerrands and Chinese Pandas. He adds it's also important to diversify storage facilities.

Mining stocks also offer exposure to gold's upside. Newmont Mining (NEM) is among the largest and most sensitive to gold prices. For exposure to both miners and gold itself, take a look at the Tocqueville Gold Fund (TGLDX).

The real question remains just how heavily to dive into gold, regardless of the vehicle. Browne says while Northern Trust tailors investments to the client, the bank's flagship growth and income portfolio has had a 5% gold allocation since the second quarter of 2009. This change came because "broadly across all of our clients we feel strategically gold is appropriate. My guess is it will only increase over time."

Browne and Sharma suggest current events will support the yellow metal. Sharma says Merrill Lynch forecasts gold prices advancing to $1,500 in the next 12 to 18 months. "We expect to see a rise in commodities prices, especially in oil. As economic growth increases, it's logical," he says.

Demand for gold in general has risen in 2010, according to the World Gold Council, a trade organization. In a report on second-quarter demand that was released in August, it said total gold demand rose 36% compared with the second quarter of 2009, to 1,050 metric tons, with the bulk of that coming from investors rather than buyers of jewelry.

Investment demand rose 118%, to 534.4 tons, and of that segment, ETF demand represented 291.3 tons, which was a 414% rise over 2009's second quarter. The high price of gold has caused jewelry demand to slacken; it was down 5% to 408.7 tons in second quarter 2010. Industrial use makes up the rest.

The supply of gold has increased somewhat—total mine supply was up 6% in the second quarter of 2010 versus 2009—but most of that increase comes from newer, smaller mines, rather than the larger, established mines. Recycling of gold—that is, gold that is sold from selling jewelry and such—rose 35%. This increase, spurred by high prices, and came mostly from non-Western markets, the World Gold Council said.

While jewelry purchases remain the No. 1 demand-driver, the huge rise in investment demand has altered that landscape, and if trends hold, investments will eventually overtake jewelry as the main engine.

The huge rise in ETF demand is not surprising, since investment managers see it as a more efficient way to own gold than buying and storing bars or coins. "Twenty-five million in gold is not easy to store," says Browne of Northern Trust

When investing in gold, keep in mind that the tax treatment for physical gold and physically backed gold ETFs is different from the treatment of stocks. Gold is a collectible, not a capital asset, in the eyes of the IRS. So gains on bullion, most coins and physically backed ETFs held for more than a year are taxed at a maximum of 28%. If held less than a year, they are taxed as ordinary income.

ETFs based on futures or derivatives are treated differently, with 60 cents of each dollar of income treated as capital gains and 40 cents treated as ordinary income, regardless of how long they are held.

Bottom line: Investing in gold makes sense right now, but it demands some serious care. For good or ill, not all of us have the Midas touch.