How to Survive the New Gold Rush
Investors Race Into the Hot Commodity, Even as Advisers Warn That Gains May Have Peaked; Beware the Tax Hit
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Gold has been riding its reputation as a safe haven to new highs. But it also carries substantial risks for investors.

With fears of a U.S. recession prompting investors to abandon stocks, the Dow Jones Industrial Average is down 6.6% so far this year. Gold, meanwhile, has been hitting new records. The precious metal has gained 11% this year, to $927.10 an ounce, and has soared 46% since the end of 2006. As the dollar weakens and the economy and markets appear increasingly unstable, some market watchers believe the metal is now headed to $1,000 an ounce.
GOLDEN YEARS

• Gold has lately been hitting record highs, but it comes with substantial risks for small investors.
• Pure-play gold investments can be extremely volatile.
• Though it's seen as a hedge against rising prices, gold hasn't always kept up with inflation -- and it can wreak havoc on your tax bill.
• Broadly diversified funds that hold a wide range of commodities, including gold, may be a better bet for investors, advisers say.

Investors, for their part, poured a net $6.1 billion into precious-metals mutual funds and exchange-traded funds, or ETFs, last year, according to investment research firm Morningstar Inc. Many investors are getting access to gold through exchange-traded products like streetTracks Gold Shares, which is designed to track the price performance of gold bullion, minus fees. ETFs resemble traditional mutual funds but trade throughout the day like stocks.

Gold can help investors diversify and reduce their overall portfolio risk, financial advisers say, since it tends to behave differently than stocks. But at current levels, investors may be paying a high price for that diversification. Though many investors consider gold a hedge against inflation, it hasn't always lived up to that reputation. The metal's price can be extremely volatile, and many gold investments come with significant tax consequences.

While the streetTracks Gold and iShares Comex Gold ETFs are popular among small investors seeking easy exposure to gold, the Internal Revenue Service treats them like collectibles, taxing long-term gains at a maximum rate of 28%. That compares unfavorably with the maximum 15% rate on long-term capital gains on securities and qualified dividends.

Financial advisers also warn that since gold is considered a haven in times of crisis -- and is less in demand for practical uses than other commodities such as copper and oil -- it tends to attract emotional, speculative investors who can amplify its price gyrations. Gold "is too narrow, it's too volatile, and historically it hasn't made that much money for people," says Randy Carver, president of Carver Financial Services in Mentor, Ohio.

Some also see risks to gold investors in the current market. The dollar's long decline may be near an end, some market watchers say, and if it rebounds, that's likely to hurt gold.

Indeed, some advisers who have recently used gold in their clients' portfolios are now backing off. Don Martin, a financial planner in Los Altos, Calif., told clients to buy gold last summer. But "now it's burned itself out," he says. "Gold and other precious metals are too high-priced to be a safe haven."

Investors should avoid rushing into the metal in times of crisis, advisers say. A recent study by researchers at Trinity College in Dublin found that, while gold generally holds up well when stocks decline substantially, that effect is short-lived. "Most of the safe-haven effect comes in the first couple of days" after a stock decline, says Brian Lucey, associate professor of finance at Trinity College and co-author of the study. Individual investors who try to buy in a few days after a stock slide are likely to miss many of the benefits of holding gold, he says.

Advisers say that for most investors, a broad commodities fund with a small allocation to gold is a better bet than a pure play on the precious metal. Fund companies have rolled out a number of such products in recent years, including some that offer broad diversification at low cost.

Gold has continued to climb this year as the Federal Reserve signaled its willingness to further cut interest rates. Last week, the Fed cut the federal-funds target rate by three-quarters of a percentage point, and is widely expected to cut it further when it meets today and tomorrow. Rate cuts, which tend to weigh the dollar down, generally help the price of gold. An increasingly cloudy financial and economic picture and geopolitical tensions have also helped to spur gold to new highs.

Yet gold doesn't produce earnings or pay dividends, and its returns over the long haul often look less enticing. From 1969 to 2007, gold was more volatile than the Standard & Poor's 500-stock index and produced substantially lower returns, according to Gerstein Fisher, a New York financial-advisory firm. A dollar invested in gold at the beginning of 1969 would have grown to less than $20 by the end of last year, compared with nearly $50 for the S&P 500, according to the firm.

What's more, gold has failed to keep pace with inflation in recent decades. The average 1980 price of gold inflated to 2007 dollars would be $1,563 an ounce, well above today's price, says Brad Zigler, managing editor of Hardassetsinvestor.com.

Advisers say investors should opt for diversified funds that include gold-related holdings -- and hold on to them for the long term. One option: precious-metals funds, which generally buy the stocks of mining, processing and distribution companies. American Century Global Gold focuses on gold-related companies, while funds like Oppenheimer Gold and Special Minerals and Franklin Gold and Precious Metals invest more broadly in precious-metals stocks.

But since they hold stocks instead of bullion, such funds can be buffeted by the same winds as the broader stock market, diminishing the diversification benefits of a gold investment. They also tend to invest heavily in overseas companies, so investors considering them should keep a close eye on their overall foreign-stock allocation, advisers say.

A 5% to 10% allocation to a broadly diversified commodities fund is a better way to include gold in a portfolio, many advisers say. These funds often track indexes that include oil, wheat, copper and other commodities, as well as gold. Like gold alone, such funds will generally behave much differently than stocks -- and they can reduce risk by spreading investors' bets among many hard assets.

Investors should pay close attention to the commodity index tracked by such funds, seeking the broadest basket possible, says Morningstar analyst Sonya Morris. Some indexes are far more diversified than others.

While offering broad diversification, commodities funds can be complicated vehicles for small investors. Many use futures contracts to track commodity prices. Typically, 60% of the gains on these contracts are taxed at long-term capital gains rates, while 40% are taxed at short-term rates, creating a maximum blended tax rate of 23%. Relative to the collectible tax rate, that's "a good outcome for individuals," says Robert Gordon, president of Twenty-First Securities Corp.

Many new products are structured as "exchange-traded notes." Since many of the notes essentially represent the issuer's promise to give investors the return of an index, minus fees, they eliminate the risk of tracking error. But they also saddle investors with the risk that the issuer will default.

The IRS has also asked for comment on the appropriate tax treatment of exchange-traded notes. Given the uncertainty, it makes sense for tax-sensitive investors "to house these in tax-sheltered accounts," says Morningstar's Ms. Morris.

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