HIGHLIGHT: ART INVESTING

Colourful ideas for any portfolio

RANDALL WILLETTE

Many of the gains made by high net worth individuals in recent years have been a result of strategic diversification into a broad range of asset classes.

Most recently, this trend has extended to investing in art, as investors shift their focus from weathering the financial crisis to anticipating the inflationary effects of rising government spending and debt.

Art, like gold, is classed as a 'real asset' and has proven a natural hedge against inflation. A number of funds and private investment clubs have emerged for individuals looking to put a portion of their wealth into sectors of the art market as a safe haven.

Art investment strategy

Art is increasingly becoming a part, albeit a small one, of the portfolios of wealthy investors who are searching for alternative assets, with two distinct strategies emerging.

The first strategy is designed to emulate the world's top collectors, who tend to focus on specific sectors of the broader market. A sector-allocation strategy targets medium to long-term capital appreciation through active management of a diversified portfolio across the most established sectors, such as old masters, impressionist, modern and contemporary.

These sectors are identified for having significant size and maturity of collector base, independent market behaviour, including price performance and volatility, and a long transaction history that allows greater predictability.

The second strategy is pursued by the leading art dealers and auction houses that successfully identify financial transactions and direct art investments that can result in superior shorter-term returns.

Transactions of this nature may be viewed as a higher risk/reward proposition and often include trading opportunities to buy and sell works quickly to achieve an immediate return. An approach to managing an art portfolio cannot be static. It should aim to combine traditional portfolio management with art world best practices by drawing on a combination of research, expertise and market intelligence.

The process of determining where assets

Different strokes: the art market offers good diversification should be allocated should include a thorough assessment of art market conditions, global economic conditions, the availability of attractive investment opportunities, and suitability of investments to the risk/return profile of the investor.

Similar to industry analysis in traditional fund management, the investment process should include a curatorial review of sectors, genres and artists within each sector to determine how trends will influence the future performance and risk management benefits of the portfolio.

Art price indices

What is relatively new is the preponderance of recent data that, for the first time, provides investors with an understanding of the asset class's risk/reward potential.

Over the past several years we have seen the development of price indices that have aided the comparison of art with other assets such as equities, bonds and gold. One of the most widely quoted is the AMR Art 100 index (see charts below), created by Robin Duthy of Art Market Research. There are a number of methods of producing art price indices but all are reliant on data from the sales at the main auction houses, given the absence of obtainable data from the dealers and private treaty sales.

Strategic management

A critical element in the success of any collector is his or her ability to find attractive investment opportunities on favourable terms. Opportunity can be further managed through a combination of economic and behavioural research and access to market intelligence.

To enhance the value of each individual art asset in a portfolio, investors should consider employing the same curatorial and marketing activities commonly practiced by successful collectors and dealers through strategic promotion and exhibition.

For example, successful collectors will often seek appropriate exhibition of their collection and inclusion in an important show or at a respected institution. As importantly, assembling a group of works into a cohesive collection with a single focus can result in significantly higher prices than what each work might command on its own.

Finally, investment in art involves a substantial risk of loss. Precipitous market declines, such as the one we have just experienced in the contemporary art market, are often the result of bursting bubbles within regions or sectors. Most recently, Indian art has come into the spotlight for poor investment performance created by the fallout from an overheated market. As with any alternative investment strategy, investors must carefully consider the data and market intelligence where such activity appears to be building. Sophisticated investors will also employ non-concentration strategies to mitigate the risk of exposure to a single opportunity or sector of the art market.

Art due diligence

Unlike most other investments, the art market lacks professional regulation. Just as one should obtain independent advice when making a financial investment, the same holds true for art. This, however, is not always easy to get. Advice has been provided largely by auction houses, dealers and galleries, which may have conflicts of interest. Investors should seek advice in both the commercial and academic art worlds, from experts who have no vested interest in the works. Experts should also be recognised leaders in their field or consultants to major museums and collectors.

When investing in art, one must be keenly aware of the risks associated with the purchase of individual works, including questions of authenticity, title, condition and provenance. The insurance and safe custody of the art assets is also a component of risk management. Investors must have access to providers and facilities with expertise in these areas.

Transaction costs

In selling a work of art at auction these costs may be considerable, often approaching as much as 25-30 per cent when one takes into consideration the buyer's premium and the commission paid by the seller. One must also take into consideration costs for insurance, photography and transportation, frequently passed on to the seller by the auction house.

Transaction costs can be even higher when considering private gallery sales. The commissions paid by sellers or consignors are negotiated between the consignor and the gallery. The percentage of the selling price retained by the sales agent, or the gallery, can vary considerably. Much depends upon the valuation of the piece and the private agreement the seller or shipper is able to craft.

Direct investment v funds or clubs

When considering direct investment versus an art fund or private investment club there are a number of important factors to consider.

➤ By employing the expertise and market intelligence of a fund manager it is possible for the risks normally associated with art to be spread across a larger and more diversified portfolio. In theory, this allows investors to spread the risk in a way that is difficult to achieve with direct investment in individual works.

➤ An art fund or private club structure can reduce transaction and other costs by investing in art on a 'pooled' basis. Equally important, given its significant cash resources, an art fund or club may be able to negotiate advantageous fees and conditions with auctions houses, insurers and other service providers not normally available to any individual buyer.

➤ Works of art acquired by a fund are typically selected by leading experts in their field. Locating the right works of art to buy and disposing of them at the right time requires expert advice which may not always be available to individual investors. Expertise and being close to the market is a significant competitive advantage.

➤ An art fund or club may also have unique access to works of art that are fresh and rarely seen on the market, adding to their investment value. For example, a fund's advisers may have access to private estates and collectors, giving them the ability to source works of art directly from the owners.

➤ An art fund may be structured to provide certain investors with a tax-efficient means of investing in art.

Of course, all of the above are only achievable if the art fund or club is well managed and the decisions to buy and sell are made by experienced, independent and objective advisers.

When analysing the potential benefits of art to a portfolio one should consider the possible long-term advantages of inflation protection, volatility reduction for the overall portfolio through low correlation and higher risk-adjusted returns. However, this must be balanced with other client-specific requirements such as liquidity needs and time horizon. It is also prudent to add different asset classes, which provide varying degrees of inflation protection over differing time horizons. Riskier assets such as art require longer holding periods to ensure positive real returns. Ultimately, whether an investor chooses to integrate art into their alternative investment strategy must rest with them and their investment manager.

Randall Willette is managing director at Fine Art Wealth Management

Rock solid: investing in works can have both long and short-term benefits

main points

» Many of the gains made by high net worth individuals in recent years have been the result of strategic diversification into a broad range of asset classes

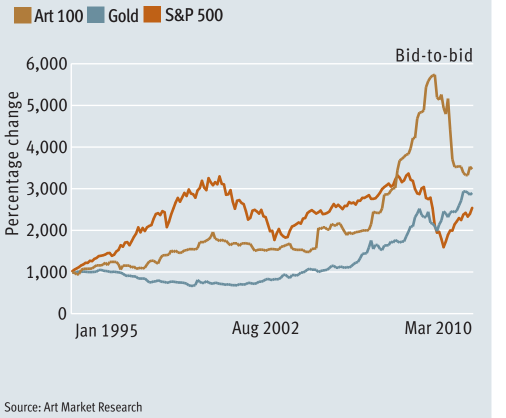
» Most recently, this trend has extended to investing in art, as investors shift their concern from weathering the financial crisis to anticipating the inflationary effects of rising government spending and debt

» What is relatively new about art investment is the preponderance of recent data that for the first time is providing investors with an understanding of the asset class's risk/reward potential

» However, investing in art lacks professional regulation and still involves substantial risk of loss

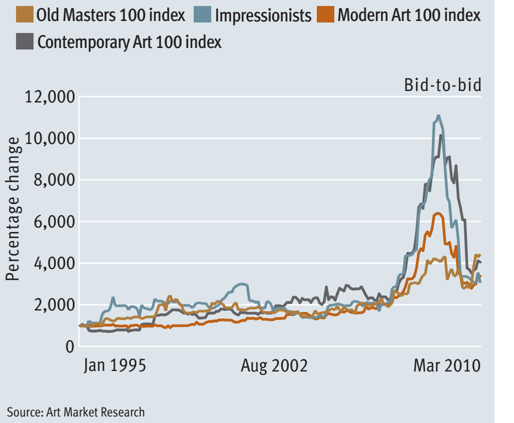
» Market decline is often manifested by a bubble bursting – seen most recently in India, where an overheating of the contemporary art market sent investment performance tumbling

Performance of art, gold and S&P 500 since 1995



Source: Art Market Research

Performance of art market sectors since 1995



Source: Art Market Research