

# Art as an alternative investment

The comparatively poor performance of traditional asset classes in recent times has made it necessary for investors to look further afield for better returns. Traditional alternative investments such as real estate, commodity futures, private equity and hedge-fund investments have been experiencing a huge growth precisely because they offer low and even negative correlation with equities. In addition to these traditional alternative investments a number of funds have emerged which specialize in art. This article offers a short overview of the reasons why investors are turning to art and what an investor has to look out for when investing in art.



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The benefits of investing in art are best demonstrated with the following example: In November 1987 Van Gogh's painting *Irises* was sold for US\$53.9 million. When the picture had previously come on the market in 1948 it was sold for US\$84,000, the equivalent of US\$500,000 in the year 1987. Over the three decades between the two sales, the painting therefore averaged a return of 12.5% p.a. on the original investment, whilst other alternative in-

vestments over the same period averaged a return of 8.6%. More recently the example of Mark Rothko's painting *White center (yellow, pink and lavender on rose)* was bought in 1960 by David Rockefeller Sr. for US\$10,000. In May 2007 it was sold for US\$72.8 million. There are many other such examples to demonstrate that art as an investment can be financially rewarding.

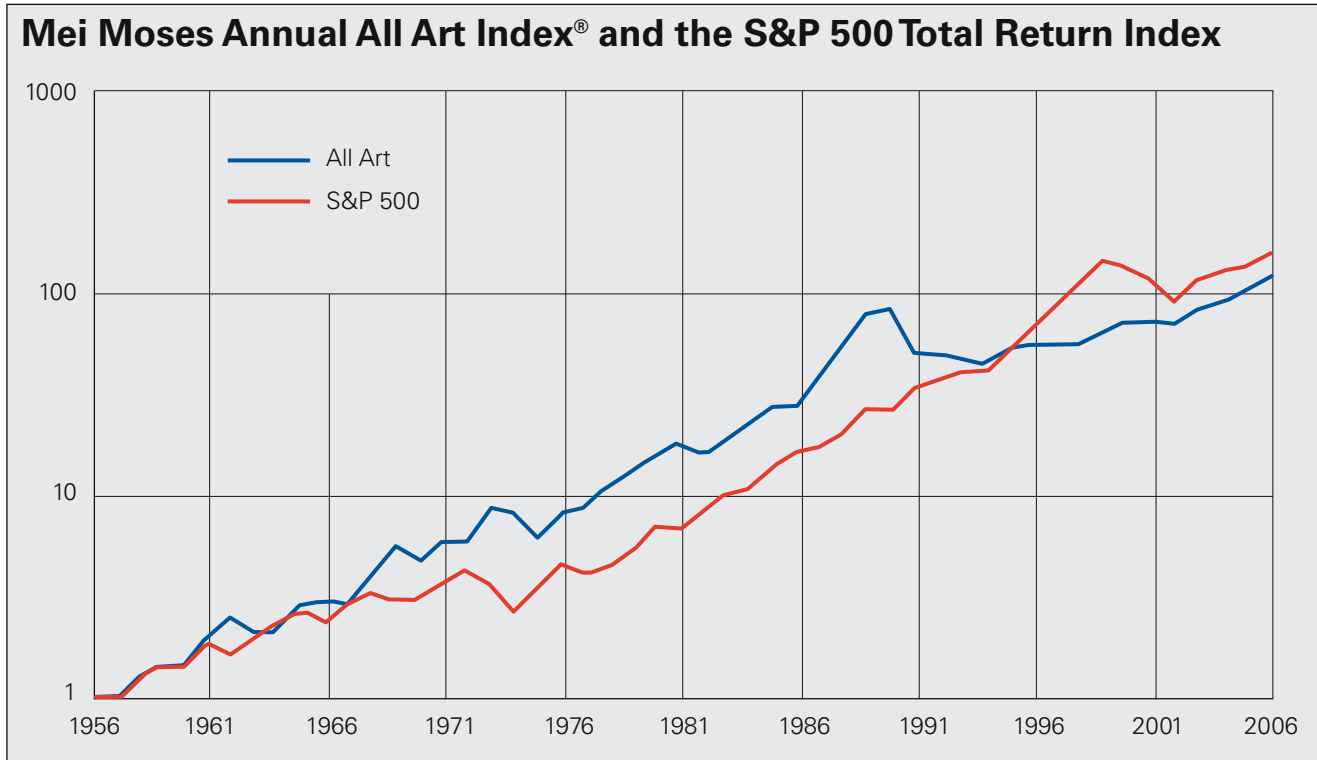
## Tracking the performance of art

Over the last few years there has been an increase of financial professionals and academics focusing their attention on the art market and analyzing it with a host of analytical tools. Notably two professors at New York University's

Stern School of Business, Michael Moses and Jiangping Mei, have been compiling data to track the long-term performance of fine art, thereby providing an investor with the possibility of comparing the performance of art with other indexes.

Based on the chart "Mei Moses Annual Art Index® and the S&P 500 Total Return Index", the following can be said: The most recent annual five- and ten-year returns for art, 11.6 and 8.5%, exceed the returns of the S&P 500 stock index, which achieved 6.1 and 8.4% respectively.

In a previous paper in 2002, Mei and Moses further compared the returns on investment of art with other



asset classes, showing that even over longer periods art can compete with other asset classes. In the same paper they further compared the volatility of art with other types of investments and concluded that art, with a volatility of 21.3% for the period from 1950 to 1999

was just a bit riskier than the S&P 500 stock index with 16.1%.

**The risk/return tradeoff**

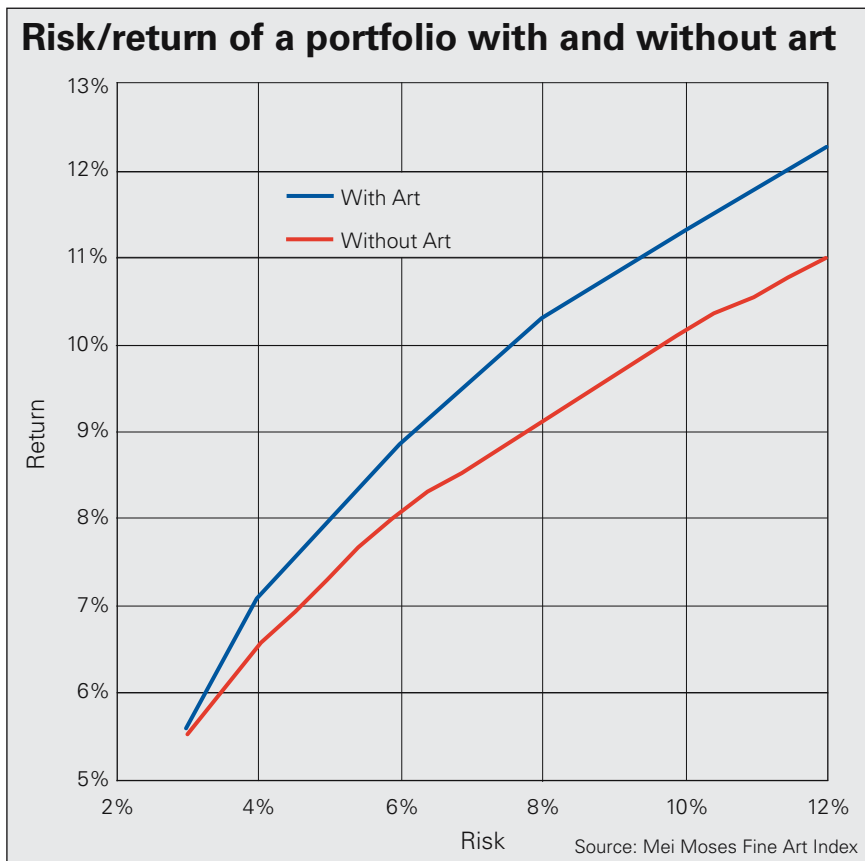
Using their data, professors Mei and Moses also compared the risk/return tradeoff. They compared an investment

portfolio of stocks, bonds, cash and gold with a portfolio using the Mei Moses Annual All Art Index® as a possible investment alternative. The chart “Risk/return of a portfolio with and without art” demonstrates that adding art as a diversifying element to a portfolio tends to reduce the risk of the portfolio for most levels of return (e.g., for an expected return of 10%, the risk of an optimally balanced portfolio is reduced from about 10% without art to about 7% including art). As returns on art are not correlated with returns on shares, one can say that owning both art and stocks reduces the volatility of a portfolio, whilst returning about the same amount.

Investing in art as part of an asset-allocation strategy therefore makes sense, reducing the overall financial risk in terms of the variability of returns for a given level of expected return.

**The best portfolio mix**

Barclays Capital also looked at how art and other assets performed over different phases of the business cycle and over different periods of time, using data from 1970 onwards (Equity Gilt Study, published in 2005) and concluded that art performs best when the economy is growing. Art also proved itself to be more resistant to inflation



than other assets. Barclays Capital further asserted that the return from art regularly exceeds the return on bonds and broadly moves in line with property and, to a lesser extent, with commodities. They concluded that the best portfolio mix, with an investment horizon of ten years or more, would include a 10% weighting in art. The Glenmede Trust came to a similar conclusion by using the Sharpe ratio. Based on their assumptions, an ideal portfolio would contain a 15% weighting in art.

Given these figures, it becomes clear that investors cannot bypass the possibility of investing in art without due consideration. The art market, however, is different to other asset classes and the investor has to bear the following specialities of the art market in mind when considering an investment.

### **The difficulties of investing in the art market**

The primary difficulty of investing in the art market derives from the art market's inefficiency, from the know-how and expertise that the art market requires and from the uncertainty surrounding tax issues.

Market transparency is low and there are potentially large differences in expertise between buyers and sellers. Furthermore there is low liquidity and buyers and sellers are often distant in terms of space and time, making it hard to find a buyer when someone wants to sell and vice versa. Also, transaction costs (one-off fees include auction fees [ca. 25% of the purchase price] and transport costs [1%]) as well as annual insurance and handling costs (0.5 to 0.75%) are far higher than in other markets.

However, not all of these costs are entirely to the investor's disadvantage and some can be avoided: When a purchase is made directly from the owner, no commission has to be paid. Also, the lack of liquidity has the advantage of creating a positive "buy-and-hold" mentality in the market, making the market more stable and less prone to impulsive actions. The inefficiencies in the art market also mean that knowledgeable investors can still achieve a performance not easily obtained in the overanalyzed equities market. And, fi-

nally, investing in an art fund does have the advantage of being able to circumnavigate these difficulties.

### **Art funds**

In an attempt to counterbalance the inefficiencies of the art market, investors have been constructing vehicles specifically along the lines of hedge funds, private-equity funds and mutual funds to allow investors to buy shares in a pool of art. Despite the advantages of investing in an art fund, however, many have failed to get off the ground or leave their mark. This can be explained by the special nature of art. Although the data shows that art performs well as an asset over time, those interested in art will have little interest in these funds, as the emotional satisfaction of buying a work of art is missing. This observation counts as much for the Russian and Chinese buyers, who are presently investing heavily in art, as it did for the Japanese during the boom-and-bust years of the 80s. It can therefore be said, that someone in a position to invest a few hundred thousand francs or more in art is unlikely to invest in a private-equity fund.

Therefore, despite the apparent advantages of an art fund, the slow growth of art funds compared to the overall market would suggest that buyers still prefer to buy individual pieces of art.

### **Buying art**

Once the decision has been made to invest in art, the following points should be kept in mind.

#### *Quality*

One of the factors that have proven to be resistant against most other external factors is quality. Even in difficult economic conditions a painting of exceptional quality will find a good price on the market. Generally speaking, quality in the art market means that a work of art reflects a typical style of an artist's oeuvre and that the work clearly differentiates itself from other artists' work. Quality also has something subjective about it; the opinion of an art expert or opinion leader will therefore also carry a considerable amount of weight in determining the quality of the work of art.

#### *Rarity*

No more than in any other market, rarity determines the price. With regard to fine art, paintings are unique and will therefore intrinsically hold a certain value. But rarity also means the rarity of works of a given artist on the market at any given time. This is important, because the uniqueness of a work by an artist is undermined, if too many of his works of art are on the market at the same time. It also sends a signal to the potential investor that there are plenty of works available on the market and that there is therefore also plenty of time to choose. But if a work of art is offered for sale and does not reach its minimum price, word quickly spreads, destroying the value of any other of the artist's works for the future.

#### *Authenticity*

Authenticity, or what is regarded as authentic, is a driving force behind the price. For example, the works of art accredited to Rembrandt (1606–1669) have been shrinking over the last decades. At the beginning of the 20th century there were still 1000 paintings attributed to the great artist; today there are ca. 250 which are considered to have been painted directly by the artist. Cases where the opposite has occurred and a painting was belatedly attributed to a famous artist also exist, but they are far rarer.

The investor always has to bear in mind that despite the increased use of scientific methods, claims of authenticity are not an exact science and the final decision on what is authentic or not is often determined by the "expert eye". Especially people buying from galleries or private collections need to be wary. Gaining as much information as possible from the seller – and if possible from the artist himself or herself – will help avoid buying a fake.

#### *Condition*

When considering a purchase, the buyer should always request a condition report, preferably written by a professional art restorer. This is important for insurance reasons, in case any damages occurred during transportation or through other events during a previous ownership. It also documents the state

## Performance of various artists

		Q1 2006		Q2 2006		Q3 2006		Q4 2006	
		Price (€)	Price development	Price (€)	Price development	Price (€)	Price development	Price (€)	Price development
<b>Blue-chip artists</b>									
Karel Appel	1921–	875,414	+26%	3,330,623	+17%	425,740	+20%	2,723,237	+30%
Jean-Michel Basquiat	1960–1988	1,022,586	+24%	12,225,816	+24%	810,870	+9%	6,031,255	+14%
Keith Haring	1958–1990	310,241	+17%	2,053,977	+7%	430,785	+14%	2,482,078	+12%
Roy Lichtenstein	1923–1997	3,222,011	+18%	16,985,634	–22%	1,117,977	–20%	24,180,595	+7%
Gerhard Richter	1932–	5,507,430	+24%	9,787,784	+19%	2,670,868	+30%	13,595,927	+30%
<b>Shooting stars</b>									
Andreas Gursky	1955–	451,876	+15%	3,158,198	+15%	1,309,033	+9%	4,351,982	+10%
Damien Hirst	1965–	942,566	–13%	6,716,218	–7%	1,487,835	–9%	5,396,977	–11%
Thomas Ruff	1958–	258,985	+29%	1,004,186	+25%	406,115	+28%	914,594	+18%
<b>Ancillary artists</b>									
Jörg Immendorff	1945–	75,589	+57%	197,131	–24%	214,274	+35%	444,394	+47%
Sigmar Polke	1941–	2,494,854	+47%	938,604	+59%	373,815	+34%	642,506	+31%

Price (€): Total sales price of all the paintings of a particular artist sold during the respective three months.  
Price development: Average percentage change per painting.

Source: artprice.com

of the work of art at a given time. The opinion of an art restorer will be especially important with regard to some contemporary works of art where artists resort to untypical materials (e.g. chocolate used in some works by Dieter Roth or butter used in Joseph Beuys' works).

### Provenance

Another risk factor is the origin of the painting. The best protection against buying stolen works of art is to have a complete list of all previous owners. This has the indirect advantage that the value of a painting will increase dramatically, if the painting was previously owned by someone famous.

### Access to market

When considering art as an investment, it is best to focus on internationally renowned artists, as local artists typically can never reach as many potential buyers.

### Emotions

One important factor inherent in the price of a painting, which hardly plays

a role when buying stocks and bonds, is the emotional element involved. The emotions can be based on a momentary burst of interest in an artist, the superior marketing skills of the seller or the individual passion that a buyer develops for a painter. These emotions are best predicted by understanding the art market and getting a feel for current trends and fashions.

### Who is "hot" at the moment?

Various websites and magazines give overviews on current developments of the art market. Without prejudice, the table "Performance of various artists" gives an idea of the performance of various artists in 2006.

### Conclusion

Art has a low correlation with other assets and thus may play a role in portfolio diversification. However, successful investment in art requires not only extensive know-how about the artistic quality and authenticity of the object to be acquired, but also knowledge of the peculiarities of the art market. Additionally, it requires the in-

vestor to develop a sense for future market developments, including international factors such as exchange-rate movements as well as cultural and market preferences. Tax uncertainties are also another main concern when investing in art. In many countries investment in art is one of the possibilities of optimizing ones tax planning, especially if it is unclear under which jurisdiction the purchase falls.

Finally, the decision to invest in art not only leads to owning an object of beauty, but also allows the investor to partake in an acquisition process which entails strong cultural and social elements unknown to other asset classes. The acquisition process includes the gaining of knowledge of a work of art and allows the investor to meet like-minded collectors and experts. There is also the thrill of the "chase" and the excitement surrounding auctions. The longevity and financial performance of art is, in some respects, just an added bonus.

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