

Evaluating art as an alternative investment asset

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Abstract

This paper constitutes a discussion of the trend around the proposition that art can be considered an alternative means of generating a return using structured funds as vehicles for investment. With financial markets in turmoil, art as an alternative asset class is being incorporated into portfolios in the interest of diversification. However, the volatility and illiquidity of the art market makes it hard to compare with more conventional investments. This paper will look at how investors are treating art as an asset class and how it compares to more traditional assets such as equities and bonds. We investigate two art funds, the London Fine Art Fund and The Art Trading Fund, and assess how they operate as vehicles for investment. We look at whether these art funds can be deemed successful, what has made them operate effectively, and their relative risk as an investment class. In summary we find that art's low correlation with the equities market and desirable risk and reward ratio makes it an attractive investment, but that timing of sales and purchases plus the holding period of an investment are key criteria for generating a return.

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The role of art is changing and it is no longer just appreciated for its aesthetic value and the expression of its lofty ideals. It is now also viewed as an investment. Developments within the art market over the last ten years in the U.K. have been closely followed. Prices paid for pieces have gained international publicity and art as an object of investment has become particularly alluring. The art industry has also begun to expand to a sector size that has fueled increasing interest: it is now worth over U.S.\$3 trillion and has an annual turnover of U.S.\$30 billion [Thomson Financial Data (2006)]. It has its own indices for tracking performance (Mei Moses All Art Index, Art Market Research), where we find that returns are just as attractive as the stock market, if not better.

While art as an investment class has been debated for quite some time, there has been little investigation into the reasons why only a handful of the many small art funds have prospered during the past few years. With uncertain stock market returns and the economic slow down, high net worth individuals are now considering alternative investment avenues. What makes art as an investment special is that it has witnessed sustained demand, has limited supply, and always seems to endure economic downturns. Although putting money into art is not as clear-cut as investing in equities, the market is attracting increasing interest. We propose that art as an asset is in a class of its own, with features that merit further investigation. While art is seen by many from within the financial community as an attractive investment, it is also extremely risky. It is an alternative investment earning capital gains rather than a dividend. Art does not behave in the same way as other assets. As investors take on a more in-depth and measured approach to portfolio management, there are investors willing to consider diversification strategies that encompass more exotic investment classes, one of them being alternative investments in art.

In order to understand the nature of art as an investment we must first assess the nature of the market for this class of asset. This will help in the exploration of the limited supply of potential investment assets and their nature in relation to their price over time. We will assess two case studies of art investment funds to look for patterns of success in this type of investment vehicle, then move on to explore the financial performance of art in comparison with a variety of indices. We sum up by assessing the future of art as a credible investment opportunity.

General characteristics of the art market

The art market is divided into the primary and secondary markets. The primary market concentrates on the sale of contemporary art, made by living artists selling works of art mainly for the first time. The secondary market, for resale, deals with mainly ancient and modern art, where the artist is dead. One of the major problems with the secondary market is the restricted number of quality works to be found for sale. Art funds that have been set up mainly deal

with the primary market, as the value of the product is so uncertain that it makes establishing a potential return very difficult. The field's activity relies heavily on promoting artists and establishing current states in arts.

The sale of art can be characterized as an oligopoly, as it is controlled by the few major international auction houses based around the world (Christies, Sotheby's, Phillips, and Bonhams). In terms of world markets as a potential of sales, the U.K. together with the U.S. account for over half of the world's trade in works of art [Jyrämä (1999)]. The oligopolistic constraint in terms of sales also acts to restrict the number of artists and works that come to the presence of buyers via the auction route. The leading global auction houses operate as 'taste makers,' which choose among the population of artists at large and identify a much smaller number for further promotion and selection by private collectors and institutions [Simpson (1981)].

The framework in Figure 1 captures the macroeconomic environmental factors that influence the art market [Post (2007)]. We have used this as a summary of the key strategic forces that shape the way the art market operates now, but also for the immediate future

Political	<ul style="list-style-type: none">• Stronger legislation to be adopted by E.U. countries against crimes for forgeries in the market.
Economic	<ul style="list-style-type: none">• The depreciation of U.S. dollar in recent years has had negative implications on companies who have significant U.S. exposure.• Higher oil prices have led to increased distribution costs [Keegan (2007)].• Fakes remain a serious problem for the art industry. The financial harm to collectors and museums can be huge, as can the damage to an artist's reputation if substandard pieces are attributed to them [Guardian (2008)].• The increase in global GDP over the past decade have had a knock-on effect on consumption [Merrill Lynch (2006)].• There are still questions around the current credit squeeze and how this will affect the art market.
Social	<ul style="list-style-type: none">• There are concerns about the availability of suitable finance with the appropriate liquidity (a key one being city bonuses) being reduced in 2008 with the knock-on effect to art investing.• As the population ages, tastes are becoming more conservative. Wealthy professionals who might once have spent large sums of money on a collection of sports cars are now far more likely to have just the one car and a collection of paintings [Art Trading Fund Investor Report (2007)].• There is a shift towards art appreciation within the broader consumer base. This assertion continues to be supported by the increase in art fairs and auctions.• Rising economic growth of BRIC (Brazil, Russia, India, and China) countries is fueling growth in consumption of fine art.• The Internet, and in particular the website eBay, is impacting how art is sold online.
Technological	<ul style="list-style-type: none">• New technological devices, like the Internet, and new movements in art, multimedia, and video, are fueling growth and entry, and encouraging new market niches for collecting.

Figure 1 - A PEST analysis of the art market

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(two years hence). Our key findings demonstrate a mix of positive and negative factors influencing the art market.

The economics of the art market

Art is a heterogeneous product as artworks are unique. Loyalty to an artist can often be low and the perceived value of the product very much depends on an art dealer's taste, which of course has a direct correlation with the dealer's ability to generate commission revenue from the sales of that artist's works. There is a lot of competitive pressure in the industry and barriers to entry are high due to high fixed costs. These include the finding and commissioning of artists, advertising, insurance, and distribution. Costs of exiting the industry are also high as it is difficult to liquidate assets. There exists a clear mutual interdependency between firms, dealers, and art fund managers. The big three auction houses (Christies, Sotheby's, and Philips) are said to be price-makers and not price-takers. The art industry tends to compete on uniqueness of artwork and not on price – thus a kinked demand curve is atypical of the industry.

In the long term the industry will benefit from economies of scope due to new movements within art, and new markets in Africa and India. The rise of the Internet will also help open up additional revenue streams. The increased demand by high net worth individuals who want to buy art for enjoyment purposes has also been a big influence on the industry.

The relationship between supply and demand for art, therefore, appears to be very similar to luxury goods. To begin with, there is limited supply, giving art a higher value because of its scarcity and uniqueness. Secondly, the perceived exclusivity that comes with art often leads to higher prices, thus having an effect on the demand curve. There are a number of indicators that point towards an inelastic demand curve, which include:

- **Changes in taste** – tastes change, so this can affect the price at which art is bought and sold over a period of time. Choosing when to buy and sell, with the 'taste' factor, can have a significant effect on the price at which an artwork is sold.
- **Changes in income** – as incomes rise, the number of people who can afford to participate in the market for art increases, so long as the price of art falls relative to salaries.
- **Pricing and accessibility** – we have already argued that pricing has a large number of determinants, but one of the principal issues that this market faces is the accessibility to participate in the market due to the selling constraint that is placed on the market by oligopolistic auction houses and dealers.
- **Threat of substitutes** – the substitutes to art are numerous, if we consider the wider options for investing. They can include equities, bonds, property, and other specialist investments such as wine, jewellery, cars, and malt whisky.

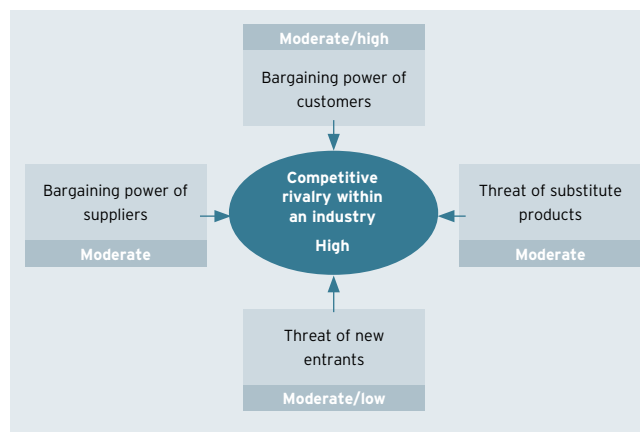


Figure2 - An industrial economic analysis of the art sector

Art prices can be assumed to be determined by supply and demand. However, there are many factors that affect the price of art within art markets, with the most obvious of these being the uniqueness of the product and the limited supply of works (especially after the artist stops producing any further works). In summary, price is very much dependent on consumer preferences and differentiation.

When costs are considered (as a factor impacting price) they can be divided into two distinct groups: production costs and selling costs [Jyrämä (1999)]. In art, as a rule, the price of the work of art consists of its production costs plus the aesthetic value of the piece. The first of these categories can vary a great deal, and it cannot be assumed that the price of an artwork is simply attributable to the time value of the artist and a simple set of input costs such as paint, canvas, and studio space. Certain artworks have production costs that add significantly to the final sale cost. A good example of this is the recently produced piece entitled "For the love of god" by the artist Damien Hirst, which is a diamond-encrusted skull with a production cost of around £14m, equivalent to one-quarter of its value [Anon (2007)]. A key selling-based category of costs that can often be discounted are those attributable to the promotion of a new artist in terms of distribution and public relation efforts. To sum up, the principal costs for the production of art can be divided into four groups: the work of art itself (direct production costs), those associated with the artist (a notional salary in lieu of time spent producing the work), the costs attributed by the market (sales and marketing costs, valuation fees), and those from the macroeconomic environment (taxes, insurance, and other duties).

There are many contributors in addition to buyers that can dominate the category we could class as 'buyer' in the art market. If we divide them between two opposing groups labeled 'pure collectors' or 'pure speculators' their motives can be disaggregated at a strategic level, with five key factors. The following issues affect the choice between buying for collection and holding art as an investment.

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- **Changes in risk** – if you are considering art as an investment, then price variations and risk factors, such as uncertain attribution, would be very important to you. You are not holding the art because of its psychological or aesthetic benefits.
- **Changes in cost** – art investors, whether they are art funds or private individuals, are affected by increases in costs, government interventions in fuel, rises in costs of storage, and insurance.
- **Unexpected changes in taxes** – investors become more attracted to the art market if it offers better opportunities for postponing tax payments than other more conventional investment assets. A major consideration for collectors is whether an increase in the value of their holdings is taxed or whether it is taxed only when sold. The latter case allows investors to reduce the variability of their return on investment [Frey and Eichenberger (1995)].
- **Changes in regulations** – globalization is increasingly affecting art; restrictions on trade in art are becoming harsher. This in turn has led to an increase in the establishment of local art markets [Jyrämä (1999)].
- **Changes in taste** – some eras in art will never go out of style and one will always receive the ‘correct’ price for the pieces. Today it is the turn of the contemporary art market, especially Chinese and Indian art. Prices have risen significantly as current demand is high.

Factors relating to the work of art include the quality, content of the work, technique used, size, and the authenticity of the artist. The artist’s fame and the valuation of previous works are important. One key distinctive feature is the rarity of the works, with the ever-important aspects of legitimization and reputation affecting both the demand and supply sides. Customers are reliant on the opinions of expert buyers to determine whether the price is correct or not. Without the legitimization of an expert, such as an auction house, it can be difficult to distinguish between what is genuine and what is a fake [Akerlof (1970)]. Creation of value in the art market can be specifically impacted by the behavior of auction houses, which act as oligopolistic quality certifiers. Art production is based on creativity, while its consumption is made possible through the interpretation of the work of art. Given that the dealer sits between the artist and the investors – and is pretty much the sole appraiser of value, not only of specific pieces but also in relation to the artists’ entire portfolio – means that they are in a specifically advantageous position and results in an asymmetric informational relationship with both the artist and the client. The artist who creates his work may not be recognized if no interpreter is available. Investors, themselves, may not be endowed with interpreting skills, facing an elevated degree of risk and uncertainty. As a result, dealers control the entire process, from determining the value that should be placed on the pieces, to how many of them are made available to the market, to how much income an artist can generate in a given year. The issue is, of course, that while controlling volumes will help

increase the value of each piece, and in turn the profit of dealer and the artist, the former will de facto determine how much income an artist can generate in a given year. Of course, the art dealers will need to invest resources to retain their credibility in the market, since it is that credibility that allows them to retain their control over the market and earn their rent, in the full economic sense. Their rent-maximizing activities limits quantities supplied and keeps art valuations higher than equilibrium prices [Mossetto (1994)].

In addition to there being no substitute for a particular art product, further benefits sought by customers are numerous and the motives for art purchasing is wide ranging. Art consultant Mr. Philippe Abdini believes that the demand for art in the Middle East region “is not only due to fashion, and it being in vogue, but to the concept of showing off to your neighbor your new found wealth” [Abdini (2007)].

Barriers of entry in the art world are interrelated. First, it is important that the artist has a reputation. Without this, galleries, museums, and art funds will find it hard to create an image of trust and expertise around their reputation. Relationships within the art world, including art experts, are also important. The knowledge required in the art business is specific to the art field and is not easily transferable to other industries. The skill of running an art business and the knowledge of art are tightly interwoven with each other. Barriers to entry do exist and come with knowing the ‘right ways’ of doing business and following the unwritten rules.

If we consider the economics of the art market using an industrial economic framework of analysis, then we see some interesting considerations for buyers seeking to buy art as investment. Figure 1 presents the key findings of Porter’s (1985) approach to industry analysis applied to the art industry, with the effect of each ‘input’ variable on competitive rivalry within the industry shown as low, moderate, and high.

Threat of new entrants – barriers to entry are medium to low. It is difficult to set up an art gallery or an art fund due to the large amounts of capital needed. There are not many art dealers out there as the job requires specific knowledge and the right connections. Large institutions, such as Sotheby’s and Christies, control a big portion of the market, and bringing an artist to the market is a costly process, thus making threats of new entrants moderate to low.

Bargaining power of customers – the bargaining power of customers for art is moderate to high as there are many customers out there, from museums to wealthy individuals, institutions, and art fund managers. Customers often have little loyalty when it comes to an artist as they either buy for personal satisfaction and enjoyment or because they see art as an investment – thus will follow what is ‘in’ today. The rise of the Internet and companies such as

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eBay, ArtOnline, and Artnet has made it easier for customers to find new delivery channels.

Bargaining power of suppliers – suppliers in this case are the artists. Their power is considered medium as without them there would be no new products or even an art market, as they originate the intellectual property. Art organizations can still lend or show work but there is no new supply of art being created. There are a great many artists still waiting to be discovered, but the process of discovery limits supply as only a small fraction of the available art is deemed a significant contribution, which limits the number of new suppliers.

Threat of substitutes – antiques, wine, products which exhibit unique design, and luxury goods all make the threat of substitute products moderate. By definition art is unique and cannot be substituted easily. Threats from other industries, however, do exist.

Competitive rivalry within industry – Competitive rivalry is high, with evidence of this seen in the ongoing competition for investor money from art funds, and a rise in the number of exhibitions, fairs, and auctions.

Art as an alternative investment asset

The comparison of art with stocks, bonds, and shares causes much dismay to many within the art community. Gallery owner Guy Peppiatt believes that, “art funds are dangerous, and unsafe for the market. They have not been set up for the right reasons and are destroying the notion of what art stands for, aesthetic beauty and to be admired in one’s private collection or in a museum” [Peppiatt (2007)]. Artist Maria Bell-Salter also deems “these funds which effectively act like hedge funds to not be good for artists. They tend to keep artists’ work in storage for at least 12 to 18 months before selling them. Art should be about enjoyment and being displayed” [Bell-Salter (2007)]. However, economists and banking institutions have shown that a link exists between art and investment.

The main attraction of the art market and the primary reason for its resurgence as an investment is its low correlation with other financial assets. Art is in a “special asset class of its own as it is generally more risky than stocks, bonds and securities and should in theory generate higher returns for investors” [Kusin (2008)]. Spencer Ewen explains the appeal of art by its “unique features, a low correlation to other stocks, a lack of transparency and a favorable risk/reward ratio, where if you get it right profits can be large” [Ewen (2007)]. Art acts as an asset because it can be exchanged for monetary value via sale.

Art fund managers have touted the inclusion of 15-30% return of portfolios as a suitable investment and inflation hedge, citing benefits such as diversification and price appreciation while recog-

nizing drawbacks such as illiquidity and high transaction costs. The market for such claims are individual investors with high net worth, who according to an ABN AMRO report have over U.S.\$30 trillion in assets, with this sum increasing by 7% per annum. The bank reports that U.S.\$300 billion is currently potentially available to be invested in art [ABN AMRO (2005)].

One of the key concerns for investors is how well an art asset can hedge against inflation. Due to the high volatility of art, it is necessary to invest over a longer period, normally five to nine years to adequately hedge [Schweizer (2008)]. There are exceptions to this rule. The emergence of India as a booming market for contemporary artworks by leading painters has resulted in this type of investment appreciating in value 20-fold since 2002. This is in economic circumstances where annual inflation has remained low. Art that outperforms inflation has become a sought after holding for an overall portfolio. The present situation of art as an inflation hedge can be explained by looking at the past: “it was the inflation panic of the late 70’s-early 80’s that was the real economic fuel behind the new vitality of the art market. This newly prosperous, aesthetically orientated generation, saw their cash eroding in value and rushed to put their money into tangible assets such as art” [Deitch (1989)]. In order to counteract the potential for losses many art dealers flaunt the tangible characteristics of art. Abdini (2007) says “it’s safer than shares, it’s always there, and there will always be a value for it.” When markets are bad, people like to invest in something they can touch [Schweizer (2008)].

Some banks support investing in art, especially for investors favoring a buy-and-hold strategy. Art gives investors optimal allocations and an opportunity for risk [ABN AMRO (2005)]. It offers superior returns, outperforms other asset classes, decreases a portfolio’s overall risk, and in some countries provides tax benefits. Furthermore, the structure of the art market is relatively unregulated, prices fluctuate, and returns can be high. “The demand for art is very much dependent on people’s wealth, the belief that this wealth will last, and on the whims of society’s taste” [Gerlis (2007)].

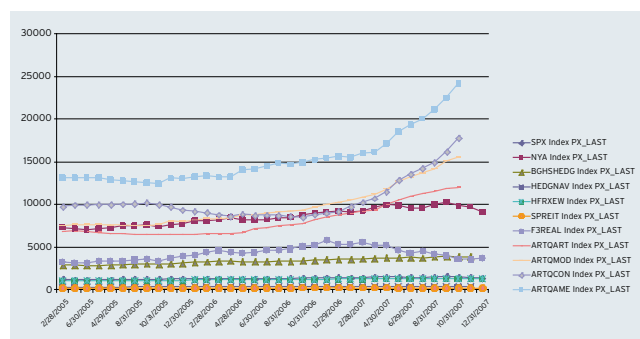


Figure 3 - Art versus all indices

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Despite the promises of large returns, many investors shy away from investing in art. To begin with, art is very volatile; as an alternative asset it has performed better in some decades than others. Looking at the overall picture, over the last two-year period annual returns for art has continued to exceed those of stocks, bonds, equities, and real estate, making it a good contender for those interested in diversifying their investment portfolio (Figure 1).

Looking historically at market data, we see that in the 1970s, gold was the best investment. In the 1980s, however, art outperformed gold, stocks, bonds, and real estate. In the following decade it slumped again. During the last decade, prior to the recent corrections, only real estate and some small stocks performed well, making art and S&P shares the worst ventures [Sandler (2006)]. Figure 1 compares four art indices from London-based Art Market Research (ArtQart, Modern Art, Contemporary Art, and American Art) with U.K. and U.S. real estate indices, hedge fund indices, bonds, and equity (The New York Stock Exchange, FTSE 100, S&P 500), over a two-year period, February 2005 to January 2008. The general assessment from art investment seems to be that returns are very much variable over time. Although they appear to show a very positive return, there are important factors related to timing, purchase choice, and general economic circumstances that impact this performance.

There are many disadvantages in art. These include liquidity, pricing, performance, costs, track records, and conflict of interests. Concerning liquidity, most art funds cannot just sell the majority of their artworks from one day to the next. For the sake of retaining their value they are normally held for a period of 18 months and are thus characterized with high illiquidity [Ewen (2007)]. Regarding pricing and performance, there is no price standardization and transparency in the market. Art fund managers can only rely on the Mei/Moses Fine Art Index, the influential Internet website artprice.com, or alternative sources of valuation such as Art Market Research. These are, however, boutique indices and have not been given the stamp of approval by any formal ratings agency. Art, therefore, needs to be estimated on size, date of creation, condition, name, and reputation of the artist. "The market is unregulated and pricing is based on strong networks and information shared between dealers and clients. It's a bit like a conspiracy" argues Abidini (2007). In relation to the drawback of costs, in the art market they are hidden. "They are associated with distribution channels in the forms of commission rates, insurance, transportation, and value added taxes. The fact is that owning art costs a lot of money" [Kusin (2008)].

To sum up, investing in art funds is a young market and track records have yet to be established. Managers of these funds may have esteemed credentials that could potentially lure investors, such as Philip Hoffman, CEO of The London Fine Art Fund who was the Finance Director of Christies for 20 years. However, their ability to achieve in this capacity has not been tested for more than a

couple of years. Inherent in fund structures are conflicts of interest, such as acquisition strategies where dealer inventory is concerned. The appraisal of the value and purchase of an artwork should always be undertaken by an independent party.

A case analysis of two art funds and their relative risk

The U.K.-based British Rail Pension Fund is the one of the most prominent examples of investments in art by a major institutional investor. In 1974, it invested more than 2% of its overall retirement fund in the art market. With good advice, and under the guidance of Sotheby's during the 1980s and 1990s, the pension fund came out a winner, with reported compounded annual returns of 11.3%. The British Rail Pension Fund's success is often flagged as positive proof of art investment. Its downfall many say was due to too much diversification.

Over the last 20 years a number of smaller investors have attempted investment funds, hoping to achieve the same degree of success. These include the Athena Fund marketed by Merrill Lynch, the Fernwood Art Fund backed by Wall Street veteran art collector Bruce Taub, the ABN AMRO Art Fund, and Falk Art Management. The most recent initiatives in formalizing art as an investment were launched in 2004 (The Fine Art Fund, owned by Philip Hoffman) and in 2005 (The Art Trading Fund, managed by Justin Williams). Both of these latter funds are privately owned and not backed by banking institutions. We will now evaluate these two independent funds to assess their organizational structures, risk profiles, and their approach to investments in art, with a view to understanding the nature of the process for generating returns from investments in art.

The London Fine Art Fund

A modest-sized private investment vehicle, it succeeded in winning funding because of the leadership of CEO Philip Hoffman. The fund has private investors who include high net worth individuals, family offices and funds of funds, and institutions. "Back in 2001, there was some resistance to the idea that art was an alternative investment. Increasingly people are becoming comfortable with this fact and as we continue to generate strong returns, the interest in our fund is continuing to increase" [Hoffman (2007)]. The fund is run like a private equity fund and has a four-tiered decision-making process. Returns for 2007 for The Fine Art Fund I, Fund II, and The Chinese Art Fund were between 10 and 20% [Hoffman (2007)].

The success of the fund, according to Hoffman, comes down to "our management structure and incentive structures for dealers. The superior team of art world and financial luminaries working with The Fine Art Fund, including Lord Gowrie, the former Minister of the Arts under Margaret Thatcher and Bruno Schroder of Schroder's plc., aims to exploit market upside and limit downside risk. There are some funds with only one dealer serving as the decision maker. Conflicts

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of interest are ripe in this type of fund. We have a longer term for the fund so we can be extremely strategic with our exit strategies, and we have a large team with multi-level decision-making process to eliminate, as much as possible, conflicts of interest and minimize risk. Dealers who align themselves to the fund are paid commissions – it is about partnering with them not competing.”

Hoffman does not believe that investing in an art fund is risky. The art market is highly inefficient, lacks transparency, is unregulated, and has low correlations to more traditional financial securities such as stocks and bonds. “All of these aspects make it a great market to invest in, but only if you know what you are doing” [Hoffman (2007)]. The Fine Art Fund points to the very low correlation between art and the equities market, making it an attractive investment for portfolio diversification and less sensitive to downturns in the equities market than other asset classes. Prices could fall for individual artists within certain sectors so one must be aware of artists’ markets when making a purchase. Furthermore, the market for Old Master works of art will continue to rise as these works are limited and extremely sought after. There is certainly enough long-term demand for the market to sustain itself and with the increase in the amount of global art buyers holding liquid assets, art investment will continue to realize high returns. “As city bonuses increase and as people are in general becoming wealthier, alternative assets such as art are becoming more attractive” [Hoffman (2007)].

The Art Trading Fund

The team behind the Art Trading Fund, the first art hedge fund, focuses on trying to exploit inefficiencies in the market. It has assembled a stable of living artists, whose work it sells to a network of buyers. Since each artist produces a steady stream of work they can be viewed as income producing assets, with a proven earning base of £2.5 million a year [Economist (2007)]. Investors comprise a mixture of institutions and private investors, roughly split 75%/25%. The minimum investment is £100,000. Thus far the fund has raised £25 million. Justin Williams, one of the Fund Directors, claims “to deliver investors a 30% return per annum. Our model is different from competitors. Returns are over a three to six month period, in contrast to competitors that focus on 10-year holding periods” [Williams (2007)].

The works of art held within the fund are collected on the basis of whether they are likely to generate steady, predictable returns. The fund has signed up a roster of artists mainly in Impressionism and Contemporary Art and has an advantage over traditional galleries and auction houses as it is able to offer rapid transactions, beyond public scrutiny, and without the risk of a sale falling flat at an auction [Financial Times (2007)]. As Williams (2007) says, “We are not trying to find the next Damien Hirst. We are looking for established artists with a track record of at least 5 years. We are buying into their cash flow.”

In recognition of the capital markets’ turmoil in 2007, the fund did not rush into many transactions. It maintained a high cash allocation, over 40% of the portfolio, and focused on driving returns primarily via the deposit rates and exhibitions which yielded a 207% return on capital invested through sales of 25% of stock [Art Trading Fund (2007)].

In terms of riskiness of art funds, Williams believes that his art fund is here to stay. “We offer a transparent structured product. Art is like no other asset. It has a strong short term performance and like every other asset bears an ‘opportunity cost’. Investors should be more concerned about the 4.5-year-old equity bull market that is reaching new heights and a bond market that faces double digit commodity inflation than our fund” [Williams (2007)].

A lot has been written in the financial press recently about the credit squeeze, following on from fear of sub-prime mortgage defaults, causing the art market to fall. The principle concern is the fear of lower bonuses for city high-earners as investment bank profits fall as a result of debt write-downs, which is being seen as a catalyst for a drop in demand for all luxury goods. The art market is supported largely by high net worth individuals, who tend to make purchases based on net wealth, rather than current income. Mr. Williams describes the art market as being “much like the high-end property market, which often continues to rise, even when conditions in the mainstream property markets become more challenging” [Williams (2007)]. With art, we are talking about assets that are funded by wealth and not income and the assets are bought with little or no leverage. This is the key to understanding the potential of art in the current environment. Art is seldom purchased with borrowed money, and money is seldom lent against art.

Summarizing the return on investment from art

We have argued so far that investing in art has multiple benefits. Unlike stocks and bonds, art prices tend to have a positive correlation with inflation. The greatest risk involved in investing in art is that there is low transparency in the market. The art market is driven by the following key attributes: art is a heterogeneous asset, there is low market transparency, expertise is mainly in the hands of the seller, there is low liquidity in the market, transaction costs are higher than in other markets, compared with other assets the art market’s drive to equilibrium is weaker, in the case of dead artists elasticity of supply is equal to zero, works of art are unique and cannot (on an individual basis) be substituted easily, and the equilibrium price is hard to determine, so an objective evaluation is difficult to achieve.

One of the key issues resulting from these factors is also a significant problem facing art as investment: the question of its economic value. The price of art is as much an emotional value as it is an economic assessment and clearly reflects variations

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in supply and demand. The highest price one is willing to pay is often attributed to a work of art as an indication of its relative attractiveness over time. This is indicative of the auction system, and in most cases the price that has been paid is not reflective of the work's true value. Works of art normally find their own value and this is in most instances not supported by quality assessments [Kusin (2008)]. The greatest challenge facing today's players is that there is no sustainable formula for assessing a work's ongoing value. This is normally done through due diligence services, by looking at past sales, and the artist's position in the market in terms of success and decline. The ultimate figure reached is purely guesswork.

Moreover, the value of an artwork stems from multiple factors; it is tied to, for example, the rising demand for artworks and increasing prices, which is driven by increasing global wealth. Value of artworks is constantly changing so one must be aware of artists' markets when buying. The Fine Art Fund considers a number of different factors when making a purchase to determine the value. These include the condition of the work, the track record of the artist at auction, and its freshness to the market, among other things [Hoffman (2007)].

So far we have demonstrated that a combination of factors in the market results in art prices behaving randomly. Art yields are predominantly derived from financial appreciation and it is market opinion that it benefits largely from surplus liquidity. Even in times of turmoil, economic downturn, and unattractive capital market trends, the art market has always managed to survive. Whilst there can be large gains and losses occurring within short holding periods, returns during longer holding periods are very close to zero, indicative of a random process with a mean of zero [Baumol (1986)]. Timing in terms of sales and purchases is therefore an essential barometer of the ability to generate a return from art.

While bonds or stocks are homogeneous goods for which markets open every day, this is evidently not the case for art; transactions for paintings for which prices are known through auction houses are infrequent. The Mei and Moses Art Index track sales in a database that now approaches 10,000 transactions. By focusing on repeat sales of the same piece they hope to account for the fact that works, even by the same artists, are not identical [Palmeri (2007)]. Other compilers of data use different approaches. Art Market Research uses results from the big auction houses but eliminates the top and bottom 10% of prices under the theory that outliers unduly influence averages. Its contemporary art index shows the category returning 8.7% over the 25 years ending in 2005 [Art Market Research Index (2007)]. This is lower than the art returns from Mei and Moses. In addition to providing some interesting comparative data, these types of indices support the case for increasing transparency to encourage greater participation from a wider pool of buyers in the market for art.

When art is considered as an investment more generally, its shortcomings include high commissions on the part of art dealers, constraints around the inability to diversify in terms of portfolio risk reduction, and in some cases burgeoning markets, which make purchases a prohibitive activity. Art does not always sell at auction, and taxes on art are high. In the U.K., artwork is taxed on sale at 28%, versus 15% for securities [Palmeri (2007)]. Furthermore, dividends are limited to the enjoyment you get from looking at the art. Whichever method is used to invest, buying pieces from emerging artists is very unpredictable. Much of the research into personal art investment (without the use of an expert advisor) shows that art is riskier than stocks when considering this approach.

The future of structured investments in art

As for the market ahead, there is great speculation into where art will be going. At this time, the market is in a great place for all sectors, especially contemporary art, with a large number of purchased pieces continuously increasing in value. Furthermore the art market is becoming more global with the emergence of contemporary Indian and Chinese art. With the emerging markets in India, China, and UAE, art pieces from these regions are becoming increasingly popular with both nationals and overseas buyers. Not only is art being bought from these countries, but as people are getting richer there are more investors from these global regions. Patriotism is also an important part of the growth of the art markets in developing countries: many collectors are buying works from their own countries as a patriotic measure and as a confirmation of their cultural identity. Ewen believes that "everything happens in cycles" [Ewen (2007)]; while the market is up right now it is inevitable there will be a decline in the future. It will be interesting to see whether the current credit crunch and looming recession will have any affect on the art market.

The results of our research and interviews have led us to believe that the majority of art funds will face difficulties meeting investor expectations, with this being the key reason why so many have failed. Going forward they need to be aware of the lack of institutional support and internal management issues related to purchasing decision-making and sales timing. High net worth individuals ready to consider investing are said to be having problems grasping the concept of art funds because of the lack of market transparency, lack of liquidity, ease of exit from the fund, and a misunderstood risk/return ratio. In order for art funds to flourish and gain public support they need the financial backing of some of the major banks. Many funds, in their current organizational structures, lack the structure, both from organizational and legal perspectives, necessary to gain such institutional support [Schweizer (2008)].

We have shown that the management of art funds poses a rare combination of experienced investment skills and a deep understanding of the arts market. Institutions and private investors are concerned with this especially when it comes to the agendas that operate

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behind the decisions that senior art advisors make. It is often difficult to disentangle their interests on behalf of the fund and their persuasive motivations in respect of their clients to buy further works of art. Art funds will need to structure themselves in a manner that protects them from such risks, and to open their internal processes up to new potential investors outside the current pool of art investors. The structuring of a fund also has implications for the deficiencies that art fund managers need to worry about when making sure that the structure of the art fund is clearly communicated. Potential investors may be concerned about the spread of investments being too high, which can have an adverse effect on the ability to buy and sell at the right time. Other management considerations include the scale of fees charged by intermediaries and professional advisors to funds in relation to the funds' ability to generate an investment return for such advice. Finally, the extra costs such as insurance, shipping, and storage must also be considered in addition to management fees, to ensure that the holding costs of an artwork are higher than the difference between the costs of purchase and sales.

Another concern for art fund managers is the fact that institutions are calling for the art market to be regulated. Many in the art world believe that this will never take place, as art indices only work in the secondary art market and not the primary one. This is another obstacle. The Mei/Moses indices are based only on auction results, not on private sales. Reliability of information makes it difficult to develop a reliable index. Another problem to note within the art market index is how often such an index can be updated to reflect current trends. The Art Market Research index is updated monthly but Mei/Moses indices are updated annually. It appears that a large majority of commentators on the industry agree that private sales data will never become available to those without insider knowledge. Rather than worrying about this issue of price transparency, art funds should be more concerned about obstacles facing them, such as removing the mystery surrounding the way they operate.

While the returns on art may not always beat the stock market, when measured against spending on rapidly depreciating alternatives, such as property or sports cars, it appears that art offers a valuable portfolio diversification if timing and investment decisions are taken with the support of expert assistance. We have shown that by considering art as an investment, the potential buyer should diversify a portfolio to overcome the potential for different classes of art to offer radically different risk return profiles. Buying the works of contemporary artists, such as brand new 'undiscovered' artists entails very high risk but potentially has high rewards. Such investments need to be balanced by less risky safe bets. However, an asset class such as art often requires the investor to know what they are purchasing and have the spending power to acquire a range of pieces to keep a portfolio diverse in nature. Often the only way to do this for new investors with less capital is to use the services of an investment fund. In doing so, the buyer must be confident that the fund

that manages their capital has both a shrewd understanding of what they are purchasing and a keen instinct for timing when it comes to buying and selling.

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