

The investment attributes of Art for institutional investors

Abstract: *This paper examines how recent market conditions have enhanced art's attractiveness for an institution's long-term investment portfolio due to its diversification and inflation-hedging attributes, as well as its ability to deliver higher risk-adjusted returns than comparable asset classes.*

We are experiencing increased long-run upward risks to inflation due to higher government debt and prolonged low interest rates. In addition, most institutional investors have realised severe write-downs in parts of their investment portfolios as well as experienced the underperformance of traditional asset classes such as equities over the last decade. In the paper, we consider the applicability of art investing to the current investment challenges faced by a typical investor.

The art market was not spared the impact of the financial crisis. Correlation between all assets shot up during the crisis, and art was no exception, albeit with a lag as demand for liquidity by leveraged investors fuelled liquidations across the asset class spectrum. The Art Market Research (AMR) Art 100 Top 25% index lost 35% in its peak-to-trough move relative to 48% for the S&P 500. Equity markets have rebounded by nearly 60% since their March 2009 low. Likewise, most sectors of the market have recovered strongly this year with robust auction results, and consequently, the AMR Art 100 Top 25% index has also rallied by 20% since its low in January 2010.

While exceptional fiscal and monetary measures may have succeeded in their short-term policy aims, there is no doubt that the latter carry long-term consequences of a more damaging nature. Chief among these are 1) Long-run inflationary Risks and 2) Higher Risk Premiums.

1) Inflation:

The fiscal positions of many developed countries have weakened sharply as policymakers shifted private sector debt burdens onto government own balance sheets. Higher inflation is the natural consequence of excessive fiscal

burdens, as a result of debt monetisation or a policy bias towards growth over inflationary discipline as governments attempt to inflate and/or grow their way out of their liabilities. Another major factor that could trigger higher inflation include increased demand for commodities by emerging markets in order to meet their industrialisation needs, combined with greater scarcity of supply.

2) Higher Risk Premiums:

Lower-than-historical asset class volatility and lower equity risk premiums in the years preceding the recent crisis are also likely to experience a secular shift, for a few reasons. Governments are likely to intervene more: to reduce their fiscal burdens through higher taxation, to re-regulate the financial industry in order to achieve desired outcomes and to ensure growth through targeted measures. Aging populations in the developed world as well as a deteriorating demographic dynamic in developing countries reduces the availability of capital. Investors would likely demand a higher risk premium to compensate for these factors.

Investment Attributes of Art

- Art delivers an annualised return since 1985 of 8.1%, using the AMR Art 100 Top 25% index. This equates to a Sharpe ratio of 0.43, exceeding that from many other comparable assets. A long-term return series for art against equity and bond indices reveals similar-sized return cycles for art as for equities, but with much lower volatility.
- Analysing the co-movements of art with other equities reveals that correlations are highest with a one-year lag for the art index, which makes intuitive sense given its 12-month smoothed nature (i.e., each new month added is replaced by the first month deleted). Hence, we incorporate this correlation lag into our study in order to be conservative. Even with this caveat, art posts only a 15% monthly correlation with the S&P 500 index. Among other assets, it is most correlated to the CSFB Tremont Hedge Fund Index since records for the latter began in 1994. It is also important to point out the overall art market reflects the behaviour of various sectors, such as Old Masters, Impressionist and Contemporary Art. These sectors often move differently from one another, providing a further opportunity for diversification.
- A key advantage of art investment, along with property and inflation-linked bonds, is that it constitutes a claim on real assets and as such, a partial hedge against inflation. Thus, a portfolio that includes art should offer a superior risk-adjusted real rate of return than one without art.

• In a similar vein to a Barclays Capital study carried out in 2005, we consider real returns from art compared to other asset classes in four different scenarios: 1) Above-average inflation and below-average GDP growth 2) Below-average inflation and above-average GDP growth 3) Above-average inflation and GDP growth, and 4) Below-average inflation and GDP growth. Art performance is strongest during periods of above-average GDP growth and inflation, but also provides protection against inflationary outcomes in low growth periods. Equity returns are most robust when growth is strong but inflationary tendencies are tame. Gold is the strongest hedge against weak growth and low inflation, or when deflation is a prospect. Commodities deliver strong real returns during several scenarios, while bond returns are poor across the board, albeit with much lower volatility than other assets. Hence, incorporating art into a portfolio of equities, bonds and gold, delivers more superior, consistent returns in wider variety of economic outcomes.

• Despite its attractive characteristics as an inflation and equity hedge, there are certain characteristics of art that make it hard to value from an investment perspective. Similar to most commodities, one cannot discount a stream of income flows to determine value. As a heterogeneous good, the yardsticks of taste and provenance also determine value in art. Transaction costs for art could add up to 20% of its value on average, constraining liquidity.

Conclusion

Studies show that assets such as commodities and real estate assets have particularly attractive inflation hedging properties over long periods, increasing their appeal for liability-driven portfolios. This trend towards investing in real assets, as well as art funds' improved standards of transparency and risk management elicited by the crisis should render art investing more attractive to institutional investors.

Nevertheless, given the disadvantages of high transaction costs and illiquidity, the most suitable approach to art investing is a strategic one. Long term holding periods not only help avoid periods of negative return, as described earlier, but also allow the investor to take a value investing angle, by seeking out quality works close to the bottom of their historical relative valuations, or buying the overall market when it is cheap. We also recommend that the investor overlay scenario analysis on to the value investing process in order to ensure that returns for the overall asset class are commensurate with his expected economic outcomes.

Full report available only to clients of Fine Art Wealth Management.

¹ AMR Art 100 Top 25% from Bloomberg

² S&P 500, as of August 24, 2010

³ Measures annualised monthly excess returns over US 10-yr nominal rate, divided by annualised standard deviation of monthly returns.

⁴ AMR Art 100 Top 25% Index and S&P 500 Index from Bloomberg

⁵ Barclays Capital Global Rates Strategy, Equity Gilt Study 2005

About Fine Art Wealth Management

Fine Art Wealth Management (FAWM) is the first wealth management consultancy dedicated exclusively to art, collectibles and other investments of passion as an alternative asset class and the disciplines required to analyse this complex field of investment. We are wealth structuring specialists in art assets and the leading provider of intelligence on art investment funds.

Disclaimer

Any unauthorized use or disclosure is prohibited. Reproduction or transmission of the publication, by either electronic or mechanical means, including photocopying, recording or any information storage and retrieval systems, is prohibited without prior written permission of the publisher. Subscribers must agree to the Terms and Conditions of Fine Art Wealth Management as posted on the website www.fineartwealthmgt.com. The information provided in this publication is intended for information only and is taken from various sources; as such we do not guarantee its accuracy or completeness. No statement in this publication is to be construed as an invitation to invest in art funds. The information provided must not be taken to be investment advice and we make no recommendations or advice relating to any particular fund, fund manager or fund performance. Accordingly, we do not accept any liability for any investment decisions you or any third party takes in relation to the information provided in this publication. Such information does not constitute an offer to sell nor a solicitation of an offer to buy any securities, investment products or investment services.

Published by Fine Art Wealth Management Ltd
2–4 Great Eastern Street
London EC2A 3NT
For more information contact Randall Willette
E. info@fineartwealthmgt.com
T. 44 (0)20 7565 1878
W. www.fineartwealthmgt.com

FINEART
WEALTH MANAGEMENT