# Why should art be considered as an asset class?

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## Introduction

For three years now, Deloitte organises an annual conference to explore the emergence of art and other collectible assets as new financial asset classes alongside traditional asset classes such as bonds, equities or real estate and gold. This year it took place on 20 and 21 October 2010 in Paris.

The main question that we will try to address briefly in this paper is: Why should we look at art as a new asset class?

The main characteristics usually used to define art markets can be summarised in the following way: high-risk investment, illiquid, opaque, unregulated, high transactions costs, at the mercy of erratic public taste and short-lived trends. Artworks do not generate any cash flows that can be discounted, except to the extent that income can be obtained through lending and incurring expenses in the form of storage, insurance and associated costs. The art markets are also currently virtually 'unhedgeable'. This short description of the art markets might be enough to discourage many to look at it.

However, if we take a closer look at the latest trends which are directly or indirectly affecting the art markets' environment, they suggest the emergence of a financial fine art market where fine art is considered as a new asset class. The simultaneity of those trends creates an environment that in the past has never been very favourable to supporting the materialisation of such a transformation.

While this analysis mainly focuses on paintings, a similar phenomenon is experienced by other groups of collectible assets, such as fine wines, rare watches, precious stones or stamps.

'Paintings' is one of the categories of the fine art markets which includes various subcategories, such as drawing-watercolour, painting, tapestry, prints, posters, sculpture-installation, photography as well as audiovisual and multimedia. The fine art markets are a subset of the arts and antiques market.

The paper is structured around three sections: a set the scene section, an analysis covering some of the factors explaining why art is considered as a new asset class and finally a glance at the market size of this new asset class.

## Set the scene

*Joseph Schumpeter once observed “Queen Elisabeth owned silk stockings. […] The capitalist achievement does not typically consist in providing more silk stockings for queens but in bringing them within the reach of factory girls in return for steadily decreasing amounts of effort”.*[1]

The fine art markets are viewed by many as a fascinating but worrying world and not so long ago, there was a perception that fine art assets were reserved for the rich and the very rich. However, fine art markets also follow the laws of capitalism, mainly due to two main phenomena: globalisation and research. With the long-termed, worldwide trend of increasing wealth, alongside the growth in knowledge about collectible markets, a much larger community has started to be interested in collecting and/or investing in rare collectible assets.

Those phenomena have created discussions on art as new asset classes to unprecedented proportions, fuelled by an explosion of art prices, especially contemporary art prices, in terms of volume of sales and record prices having been reached. Since 2004 and despite the art markets crisis in 2008, such an environment stimulated the emergence of new types of collective investment vehicles dedicated to art or other collectible assets in different places of the world to a certain level, however limited, not seen before. By applying the securitisation techniques to artwork and with the emergence of art financial products, one could wonder if art could be poised for a similar transformation to what happened to real estate 40 years ago. Real estate is today a widely accepted investment class, accessible to a large community, and is commonly included in portfolios for diversification purposes.

Another important phenomenon to point out is the increasing interest from the financial industry. While a tacit relation between art and finance has been existing for centuries, we can now see a development of art services among financial institutions and small financial boutiques. The offering mainly consists of three categories of art services, each being at a different stage of maturity.

Art advisory services, the most common in the financial sector, tend to complement the traditional range of private banking services to provide ‘non-financial lifestyle services’ in order to offer a holistic approach to wealth management.

[1] *The Economist, 19 September 2009. "Taking flight". p. 70*

Generally, art advisory services include:

- Art research: authenticity – art historical analyses – information on art market – price research
- Art transactions: purchase and sale – representation of interests
- Art management: valuation – insurance – storage – transportation – collection advisory and management
- Structured solutions: inheritance planning – art foundations and trusts - philanthropy
- Art lending: Organise lending portions of private or corporate collections

**Art lending**, not very developed by the financial sector and mainly supported by specialised boutiques, seek to turn art into a working asset. The main services include:

- Term loan: borrow against art
- Acquisition financing
- Revolving lines of credit
- Dealer inventory financing
- Bridging loans, advances and auction guarantees
- Arranging loans to museums and exhibitions

The third category, **art investment services**, is still in its infancy. It finds its source in the growing recognition of art as a new alternative asset class and supports the development of art investment products, the role of art to positively diversify investment portfolios and the integration of art into wealth portfolio analysis. No large bank has successfully entered this space so far. Initiatives mainly come from the academic world and from individuals or groups of individuals that combine a strong expertise in art and finance. Main art investment services are:

- Art investment research
- Portfolio management
- Monitoring and selection of art funds
- Structuring of art investment funds, funds of art funds and art investment clubs
- Art securitisation

Finally, it is interesting to note that today art markets provoke substantial press coverage and are covered by nearly all main financial newspapers such as The Economist, Bloomberg, CNBC, Financial Times, New York Times, Les Echos, and Wall Street Journal.

## Factors explaining why art is considered as a new asset class

In this context let's try to understand why the 'painting category' is considered as a new asset class. To discuss this point, we will briefly address the following questions:

1) What are the structuring variables of fine art markets?
2) What is the financial performance of fine art markets?
3) How to value fine arts?

### What are the structuring variables of the fine art markets?

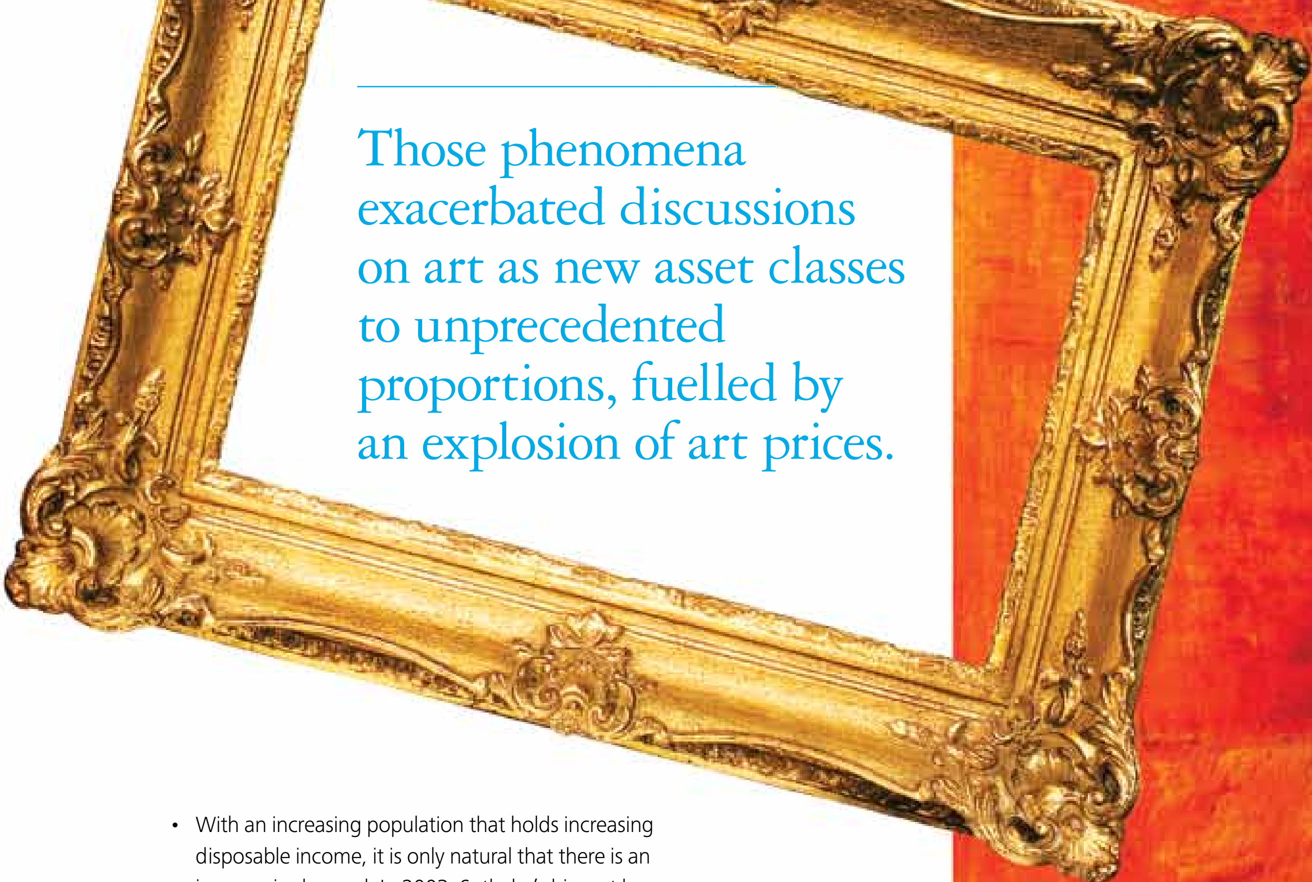
Looking at the historical evolution of fine art markets, we can observe that fine art markets have been in continuous evolution expanding to new countries and new customers around the world. Today they have reached a truly global dimension in the sense that nearly everywhere on earth people are buying and selling artwork every day and are moving around the world to find the desired item. This also showed that the art market can experience stressed periods, like a bubble period and a crash period.

Art markets are global, large and growing. It is estimated that the outstanding value of artwork is in excess of US$3 trillion with annual sales of the art and antiques market in the range of US$50 billion in 2009 down from its peak of US$65 billion in 2007[2]. After the triangulation of data, we estimated that the art markets experienced a compounded annual market growth of 8% for the period 1993-2009.

The conjunction of economic, social and technological factors supports the view of a continuous growth of fine art markets. Some of the key economic macro trends are:

- There is a worldwide increase in prosperity especially in emerging countries. Once a nation grows richer and its citizens reach a certain level of affluence, they start to buy art. This has been the general financial trend since the beginning of the industrial age. China is now third in term of sales of fine arts at auctions after the U.S. and the UK
- Art markets become more transparent due to research in finance and economics as well as data dissemination
- As more and more countries are becoming wealthier, there are more artists and an increased interest in art from a larger community
- The proportion of all luxury spending on art will continue to increase as investors look for assets that would retain their value in the longer term especially in a period of economic uncertainty

[2] *The Economist. A special report on the art market p.3. Clare McAndrew, founder of Arts Economics, November 2009.*



## Those phenomena exacerbated discussions on art as new asset classes to unprecedented proportions, fuelled by an explosion of art prices.

- With an increasing population that holds increasing disposable income, it is only natural that there is an increase in demand. In 2003, Sotheby's biggest buyers came from 36 countries. Four years later, they were spread over 58 countries and their total number had tripled (The Economist, 2009)
- The supply of best works of art will always be limited and tends to appreciate in value over time. Especially for deceased top-artists as paintings are lost, or bought by museums and collectors
- Art markets are more robust. According to Christie's CEO, Edward Bolman, the reduction of auction sales experienced at the end of 2008 and in 2009 is mainly not due to a reduction of demand but rather a reduction of supply
- Around 80% of the auction transactions are estimated to be below €10,000 which leaves the door open for many more newcomers

Social macro trends will also support the expansion of the art markets. We live in an era strongly characterised by the globalisation of cultural activities, which creates an interest in art to unprecedented levels. All societies seek to reinforce their national and/or individual identities through the acquisition of artwork of their own place and time and new museums will continue to be built: more than 100 museums over the last 25 years. However, in times of cultural spending cuts in old economies, the cultural sector has a growing need of private funding.

Technological evolutions strongly support the positioning of art as a new asset class. It increases transparency as new market opportunities and business models in an internet and digital world emerge, such as online auction houses, online databases, online and real time market data dissemination, online catalogues and fairs, artist websites and new communication channels. More people are discovering that possessing prized paintings, prints, sculptures and valuable collectibles is now within their reach.

Finally, there is a growing recognition of art as an investment asset class by investors. People become more sophisticated in their financial planning and estate planning and they begin to view art as an investment. Some take on a more in-depth and measured approach to portfolio management and are willing to consider diversification strategies that encompass more exotic investment classes, such as art and other collectible assets.

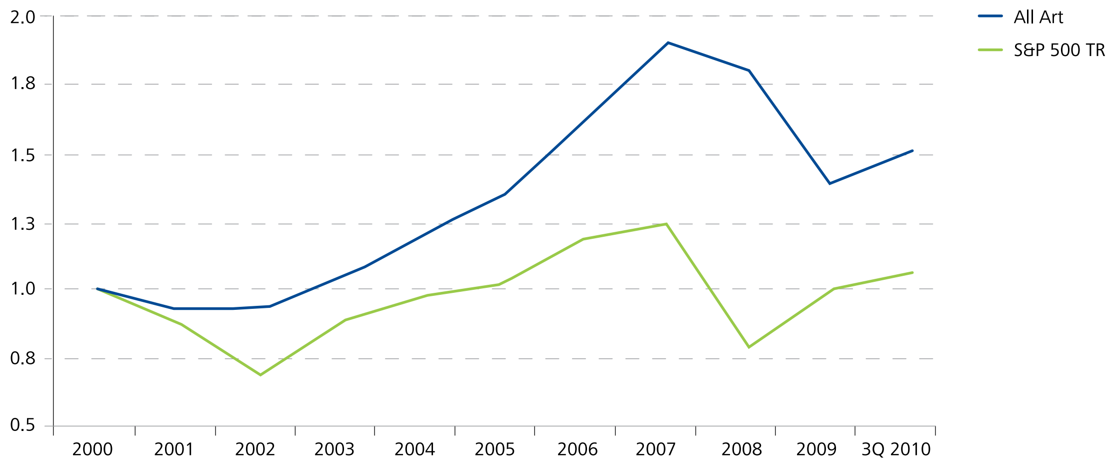
And not the least, the current socio-economic context creates a demand for 'real assets' because many lost a lot of money in the financial crisis by investing in products they did not understand and are turning back to things that are closer to their heart and which at the same time offer protection and a return on investment.

With financial markets still in flux, some High Net Worth Individuals (HNWIs) indicated they are approaching their passion investments as 'investor-collectors', seeking out those items that are perceived to have a tangible long-term value. The two categories that are the most attractive to these 'investor-collectors' are art and other collectibles (coins, antiques, wines, etc.) (World Wealth Report 2010).

### What is the financial performance of the fine art market?

Performance analyses of the art markets have been conducted for more than 30 years. A study carried out by Wolfgang Wilke from Dresdner Bank in 2000 explained that the long-term trend in inflation adjusted for art prices follows the general economic trend, i.e. art prices rise above average compared to the prices of other goods. However, most segments of the art markets react quickly and lead to a worsening of the economic environment. This is especially true for objects in the lower price category, with broad markets. An economic slowdown leads at least to a drop in demand and an increase in supply due to, *inter alia*, forced selling. This, however, does not (or only rarely) apply to all artwork in the top price category, since wealthy individuals have a substantial purchasing power even in bad economic times. Thus, the distribution of income and wealth plays a key role in assessing the price sensitivity of the individual sectors of the art market.

Mei Moeses® Annual Art Index and S&P 500 Total Return Index (2000-2010) updated Q3 2010©




Several researchers and private companies have begun to periodically publish art indices to track the movements of the fine art markets. The results of their analysis look extremely valuable, in particular if we consider the impact on transparency, provided that the methodology used is sound. Art is a heterogeneous asset that requires a methodology that does not compare apples with oranges. Currently 32 indices are accessible on Bloomberg using the ticker all ArtQart index.

The historical performance monitored by these professional indices tends to demonstrate that paintings generate moderate positive real returns that have a low correlation with the return on stocks and treasury bonds, which may give it a place in a well-diversified portfolio of financial assets, but only at the margin 5% to 10% of total assets (Artvest 2010) (Barclays Equity Guilt Study 2005).

Jianping Mei's and Michael Moses' 2010 mid October tracking report for the Mei Moses® family of fine art indices©, illustrates that the most recent ten year compound annual returns for art, 4.15% exceeded the returns of stocks, 0.5%.

Stocks outperformed art over the last 25 years with a CAR of 9.01% compared to 6.11% for the All Art Index. However, for the last 50 years the returns were very close with art achieving a CAR of 9.06% compared to the 9.56% for equities.

The risk associated with the Mei Moses® All Art Index is less than the risk of the S&P 500 total return index, 13.8% vs. 20.0% respectively, over the last ten years and 17.3% vs. 18.3% respectively over the last 25 years. The risk for the equity index over the last 50 years, 17.2% is slightly better than the art index 17.8%.

The very low correlation factors are negative 0.035, positive 0.102 and 0.135 between the All Art Index and stock indices for the last 50, 25 and 10 years respectively and its negative and small correlation with bonds for the same time periods indicates that art may play a positive role in portfolio diversification in normal market conditions. In case of a major crisis, all assets move in the same direction.

According to a recent academic study (Luc Renneboog, Christophe Spaenjers, 2009) based on data from over 1.2 million auction house sales of paintings, drawings and prints real returns in US$ term were 4% per annum from 1951 to 2007. Real returns from 2002-2007 have been 11.6%; higher over the longer term than bonds, but less than stocks which also demonstrate that art is a storage of value and a hedge against inflation which could meet investors' needs provided that an art tradable index would be available.

Professor Rachel Campbell from Maastricht University, who performs a lot of research on the subject, also came up with similar results and is setting up the International Institute of Art Finance and a set of European art indices using the same methodology as professors Mei and Moses.

These indices should be understood as only an indication of the painting category movement as they do not capture all the auction house information and any of the dealers or private treaty sales prices. Also there are not tradable and do not include the costs of buying and selling art that can be large.

Also very important to note is that the painting category is composed of several sectors that do not react in the same way. For example the old masters sector does not have the same return/risk profile as the contemporary sector. The most liquid and globally tradable sectors will most likely outperform.

There is a growing recognition of art as an investment asset class by investors. People become more sophisticated in their financial planning and estate planning and they begin to view art as an investment.

If art offers a real positive return on top of the aesthetic return, as an investment it is important to keep in mind that it also has some drawbacks such as:

- Art is a heterogeneous product as artwork are unique
- There is little chance for quick profits for not informed investors
- Art markets are unregulated
- No dividends or interest payments are made to the investor but it is also the case for other asset classes such as gold or oil
- Art is not highly liquid but neither are other asset classes, such as private equity
- Substantially more time needs to be spent to acquire specialised knowledge to be successful with fine art investments than with traditional financial investments
- Higher transaction costs should be expected with fine art investments, especially at the high end of the market which makes art a difficult asset for short term trading
- The risks of fraud and/or forgery exist

However, as the functioning of fine art markets is complex, it allows those with great inside knowledge to make substantial benefits. Therefore, it is not surprising to notice that the few art investment funds set up so far are generally set up by individuals who spent a significant amount of time in the art markets and are able to negotiate key agreements to lower transaction costs.

Under these conditions, it is most likely that they could deliver announced targeted annual return by profiting from market inefficiencies in order to buy and sell advantageously, by finding interesting opportunities when objects are sold in the event of death, discretion, debt or divorce and by anticipating trends, with substantially less transaction costs.

Finally, besides a potential increase in value, art provides additional financial benefits:

- Art provides a hedge against inflation and currency devaluation
- There is little risk of losing your principal if you purchase wisely
- No minimum investment is required
- Art investments enjoy favourable tax treatment
- Reduction of risk because of its low correlation with other financial assets
- Possibility of earning extra revenue by lending out the work or of participating in events, such as exhibitions and meetings of experts
- Art has no geographical risk and can be moved easily
- Art can be insured against calamity risk

**How to value fine art?**

Valuation is one of the most critical points when offering investment products investing in works of art. How can investors trust the performance announced when there is no transparent art pricing mechanism commonly accepted?

In finance, the price of a financial asset is determined by the market, an index and some specific factors. However, today there is no standardised art valuation methodology and there is no guarantee that the fair price of a work of art is the result of an independent quantitative analysis.

The fair price of a work of art is usually the result of a qualitative analysis provided by expert appraisers using relative valuation, i.e. by looking at how similar assets are priced in the market and at a combination of qualitative aspects of the work of art, the scarcity of supply relative to demand, consumption utility and individual perceptions.

To resolve such impediments, a suggestion made by Professor Moses is to define a methodology that combines a qualitative and quantitative approach. This methodology combines the expert appraiser's valuation to cover the emotional part embedded in the art price, the auction house appraisal to have a sense of the market and to mark to market the work of art using an index. Mei and Moses research indicates that the single strongest independent explanatory variable of the future price at auction of a work of art is the prior sale price inflated by an appropriate art market index. Their research indicates that art indices can explain 80% of the variability of the price and if you add the hedonic variables you can explain up to 88% of the variability of the price.

It is important that art markets structure themselves by recognising an index, such as the S&P/Case-Shiller home price indices created 20 years ago, and a commonly accepted transparent valuation methodology. As the research on indices progresses and more compelling databases are developed, it is quite likely that soon a family of indices will be used as recognised benchmarks which will ease and increase the use of art as an asset class.

## A view of the market size of this new asset class

**Direct investment in this market is substantial and is creating opportunities for indirect investment provided that financial instruments as well as advice exist**

What is the value of art held by private individuals? To our knowledge, a true answer does not exist. However some have tried an educated guess.

Baird asset management (2009) defined three types of collectible buyers, the pure collectors, collector/investors and investors for whom buying collectible assets is a pure financial game. In their report, they assume that the last two categories own 1/3 of the total collectibles valued around US$4.3 trillion. This estimation of direct investment into collectibles puts the value of collectibles viewed as financial assets on par with the US$1.9 trillion invested in hedge funds and the US$2.5 trillion invested in private equity funds.

Using the first Artvest Newsletter (2010) and the World Wealth Report 2010 one can compute that Ultra High Net Worth Individuals (UHNWIs) and High Net Worth Individuals (HNWIs) should have art holdings in the range of US$2.8 trillion. The total wealth of UHNWIs and HNWIs was estimated to be US$39 trillion in 2009, passion investments are estimated to comprise approximately 33% of HNWIs' and UHNWIs' overall holdings and in 2009 art holdings represented 22% of HNWIs' passion investment.

Taking a wealth driven approach and assuming that HNWIs have allocated 5% of their wealth to art and UHNWIs have allocated 10-15% to art, you end up with a market size of around US$1.5 trillion held by private individuals.

So currently, HNWIs and UHNWIs may have a direct exposure to art in the range of US$1 to 3 trillion that are barely served by financial institutions.

**Current offering of investment products investing in collectible assets is very limited**

Currently the only way to buy an indirect exposure on art is by investing in one of the few art investment funds existing or in the few companies involved in art markets, such as Artprice S.A., Sotheby's Holding Inc. or Artnet AG, traded on a stock exchange. This is a very young 'industry' in a pioneering stage which still needs to convince private and institutional investors of its place in the asset management world.

The 20th century has been marked by very few successful cases. The first one was probably in 1904 when André Level, a French financier, set up the art investment fund called La Peau de l'Ours ("the skin of the bear") which after ten years, quadrupled the initial investments of the partners. Another example is the British Rail Pension Fund which realised an overall return of 11.3% per annum during the period 1974 to 1989.

Over the last 20 years, a number of attempts (Finacor Fund, the Athena Fund marketed by Merrill Lynch, Chase Art Fund, Fernwood Art Fund, the ABN AMRO Art Fund, Falk Art Management, Christie's Art Fund, Meridian Art Fund, SGAM Art Fund, etc.) failed to take off mainly because of the difficulties to raise enough capital.

As of today, there are most likely not more than 20 existing art investment funds in the world and only one with a six year track record: the Fine Art Fund I. In terms of returns as of September 2010, the Fine Art Fund Group claims a gross internal rate of return per annum for realised assets for The Fine Art Fund I of 27.4%. The Art Photography Fund has nearly three years of existence, with only one negative month and so far has achieved an annualised performance of 8.92%. Other successful collectible funds exist, such as the Elite Advisers Wine Fund, with also three years of existence, two negative months and an annualised performance of 12.8%. Elite Advisers recently launched a fund dedicated to rare watches.

Adding the investment funds investing in other collectibles, such as wines, diamonds, musical instruments, jewellery, we estimate that the offering of public collectible investment funds is very limited. Most likely their number is inferior to 100 worldwide, with a market capitalisation that should be below US$1 billion.

As some HNWIs and UHNWIs view art as a pure financial investment and with the growing interest, there should be space for more investment products that offer an indirect exposure to art and other collectibles assets.

Hence art funds and other art structured products have to meet investor expectations by offering proper guarantees, transparency and measures to overcome the trauma caused by the Lehman Brothers and Madoff cases. They need to demonstrate that they have sound organisational structures, both from organisational and legal perspectives. They need to be transparent, explain how they deal with liquidity and performance calculation, adopt a mark to market valuation methodology, and have a track record and a critical mass to gain institutional support.

## Conclusion

Beside the aesthetic return generated by art, there are good reasons to consider art as a new asset class. Art is attractive from a financial investment point of view over the long run as it is a store of value that generates moderate positive real return. Art has also a low correlation with stocks and bonds which offer diversification possibilities over time and across the business cycle.

Art and collectible assets represent sizable assets for many HNWIs currently barely served by financial institutions. There is an opportunity for private banks and family offices to integrate the concept of collectible assets into the overall asset allocation strategy to assure adequate liquidity, avoid over-exposure to risk, minimise income taxes and organise appropriate transmission to heirs or donation to charity.

Also the gap between the estimated amount invested directly by collectors/investors in art and the existing offering of art financial products is impressive. Most likely we will see more new financial products offering opportunities to invest in this asset class and services to support customers such as advisory, legal, tax, wealth structuring and insurance.

Finally external forces, such as globalisation, knowledge sharing, democratisation, increased cultural interest or new communication channels, support the growth of the fine art markets, transform it and push for its 'financialisation'. This environment provides room for innovation. New business opportunities are created and some players have already embraced them. Several new different initiatives search to securitise several billion of US$ of artwork, such as art investment funds, tradable art structured products or dedicated art trading exchanges. Provided that they are successful, they will substantially increase the market size of art available for indirect investment by monetising a percentage of the outstanding volume.

Moreover, when dealing with tangible assets, developing these financial activities will have ripple effects on other sectors of the economy. This evolution should create a new era for the art markets and for the benefit of the society as a whole by fostering culture, knowledge and creativity.

The story is not finished yet and at Deloitte we are committed to monitor this evolution and supporting its development. Meet us at our next conference in 2011. Details will be available soon at www.deloitte-artandfinance.com.