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ART AS AN INVESTMENT OPTION

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Abstract

The paper analyzes fine art as an alternative investment option in the portfolio of investors. It also sheds light on the precautions that should be taken by prospective buyers before putting in money in an artwork. Guidelines provided include researching the artist and period of choice, working with a trusted art dealer for all transactions, and evaluating the level of financial risk involved. The paper concludes that art is a good investment in long term providing capital gains rather than dividends. The top quality art tends to be more stable than most financial investments in difficult times. According to market analyst the long term view of the prices is definitely bullish. Art is a scarce product and not reproducible at will. Rising incomes over long term ensure a steady rise in demand for works of art against falling supply. But the main attraction of the art market and the prime reason for its resurgence as investment is its low correlation with other asset classes.

INTRODUCTION

Fine art collection and investment has always been regarded as the rich man's area of interest. Few years back there were comparatively less number of people viewing art as an investment option. This perception, however, is changing over a period of time. Currently the art market in India is valued at USD 350 million and maintains a steady growth rate of 30-40 percent. This has brought this market to centre stage and also generated interest for fund houses. as well as investors. These funds typically follow the buy low sell high principle. They attract investments and buy art from undervalued sources and auctions. The value of the fund is directly proportional to the general trends in art prices locally and globally. This also depends on the artists that they have in the investment portfolio. Investment in art as mentioned earlier can be done either by purchasing the artwork of renowned artist or investing through art funds. The major investors in direct art include museums, private art organizations, private collectors, art galleries and curators. In the developed markets, the trend starts with the museums, followed by private art organizations, private collectors and ultimately the commercial art organizations. However in emerging markets like India, the trend is reversed. Here the commercial art organizations are at the top, followed by private collectors and finally public art organizations like museums being at the bottom. Therefore if one observes the trend in prices of art it is determined more on the basis of sentiments and perception than the actual auction prices.

The comparatively poor performance of traditional asset classes in recent years

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has driven the search for greater returns via alternative asset categories. The idea of reaping higher risk adjusted returns from diversification into assets that offer low and even negative correlation with equities and bonds is extremely attractive. There has been significant growth in alternative investments such as real estate, commodity futures, private equity and hedge fund investments. Among the various investment options available to investors, the following Table I highlights the risk, return and liquidity features.

Table 1: Various investment options available to an investor and their risk and return profile Vis a Vis Art/Collectibles

Investment Option	Description
Money Market Account	These work like checking accounts but pay interest (usually more than a savings account pays). You can take your money out whenever you want. But you may have a limit on how many checks you can write and the starting required balance is higher than a regular checking account. Risk: Low, Return Rate: 3-5%, Liquidity: High
Treasury Bills	Debt obligations of the U.S. Treasury that have maturities of one year or less; however T-bills can be sold before maturity. They are backed by the government. Risk: low, Return Rate: 3% Liquidity: High
Savings Account	Money you put into a bank or credit union for which they pay you a little interest. Think of a savings account as money you're lending to the bank/credit union. Typically there's no minimum balance and since the government guarantees the safety of these accounts, risk is low. Risk: low, Return Rate: 1-2%, Liquidity: High
Certificate of Deposit (CD)	With this investment, you are lending money to a bank/credit union for a specified amount of time, such as 6 months or 2 years. The financial institution pays you a higher interest rate the longer the term, and there's a penalty if you want to take your money back early. Risk: Low Return Rate: 1-2%, Liquidity: High to Low.
Mutual Fund	An investment company that pools money from several investors and uses the money to buy a particular type of investment, such as stocks and bonds. Funds are professionally

Investment Option	Description
Mutual Fund	managed and there are many different kinds of funds. Risk: low to moderate, Return Rate: low to mod., Liquidity: High
Utility Stock	Stock of a power company that owns or operates facilities used for the generation, transmission, or distribution of electric energy, which is regulated at state and federal levels. Risk: low to mod., Return Rate: mod., Liquidity: high
Collectibles	Unique items that are relatively rare in number, such as works of art or antique cars. Risk: high. Return Rate: mod-high Liquidity: low
Real Estate Investment	Investment in a piece of property, such as a land or a building. Risk: mod.-high Return Rate: 9-12% Liquidity: low
Stocks	Investments that represent ownership in a company. Stocks in different types of companies (new firms versus start-ups, big versus small companies) carry different levels of risk & return. Risk: mod.-high Return Rate: mod.-high Liquidity: mod.
Precious Metals	Gold, silver, platinum, and palladium.. Risk: very high, Return Rate: very high, Liquidity: high

DISCUSSION

Art as an investment avenue may be profitable but at the same time the risk element is high due to a variety of reasons. With uncertainty looming on the stock market, investors are considering various investments avenues. Art as an object of investment has been debated for long. But in the age, where one is getting 20 percent return from the stock market, the concept of investing in artwork doesn't seem appealing. But with the US Rating downgrade by Standard and Poor, the impact was felt far and wide. Stock markets around the world have shown lackluster performance that has once again brought attention back to this asset class. According to some experts art has outperformed more conservative investments over the last few decades. It is an investment alternative earning capital gains rather dividend. Although, according to some art can never be considered a financial asset. Critics say "investing in art disregards the traditional yardsticks of financial analysis, since they do not produce income streams that can be discounted". It is basically bet on the price movement of something whose value cannot be assessed accurately. It is also debated that art is a high risk investment, riskier than stocks. Prices of art fluctuate more widely than stocks.

Art market is illiquid, opaque and unregulated. High transaction cost is yet another reason which may eat up the profits. According to some researchers it has been observed in short term that artwork prices show considerable volatility vis-à-vis other asset classes. Also, the art market is like a blue chip investment which will bring reliable returns but obviously the entry point is higher. If one analyses stock market investment then cyclical firms dealing in automobiles , capital goods and consumer durables having a high beta value are more impacted by the changes in business cycle which consists of expansion and recession. Unlike art which remains relatively unaffected by recessionary trends in the economy. The top quality art tends to be more stable than most financial investments in difficult times. Further, the long term trend for art prices is definitely upwards. Art is a scarce product and not reproducible at will. A rise in disposable income has resulted in increase in demand for such works vis-à-vis their supplies. The thumb rule of a highly diversified portfolio is that the correlation between various asset classes should be minimum. Therefore, including art in a diversified portfolio would be good because of its lower correlation with other asset classes. But there are some inherent problems with art. Firstly, it is difficult to identify the intrinsic value of an art piece. In case of financial instruments such as bonds, debentures and stocks it is comparatively easier because investor gets cash streams in the form of coupon payments or dividend payments. Also, it becomes difficult to identify a genuine and original work of an artist. The challenge in this market is to identify artist who are lesser known and have the ability to have good potential in terms of appreciation of their artworks. Every art work is unique so comparing them is like comparing apples with oranges. Valuation is based on the price which investors are willing to pay and that to a great extent depend upon the perception of the investor towards that piece. Rival bidders who like the same piece may push the sale beyond all estimations.

Art market can be divided into five categories: Old masters, Impressionists, Modern, Contemporary and Very Contemporary. Old master art tends to hold its value because it embodies the deepest aesthetic and cultural qualities and acquire tangible investment value as a source of these qualities. However, in the case of contemporary art, so much of it is based on fashion and artists that prices tend to rise and fall very quickly. On the other hand, artwork of top artist is unlikely to fetch huge gains. It is much less likely to increase in value than middle or lower priced works, according to Mei/Moses fine art index. For art value, artist, of course, is the most significant factor, but only a starting point. To be able to attract a top price, a painting must also be thoroughly typical of the artist. Other basic components of value are authencity, condition, rarity and technique.

There are some other specific risks associated with this asset class. An investor should have the necessary knowhow about the genuineness and quality of the work of the artist. The market is not liquid because the investment horizon is very long running into decades at times. This limits an investor's ability to convert it into cash as compared to other investment avenue having high liquidity feature. There are high transaction costs in this market due to high cost associated to handling, insurance and auction fees. There is also no regulator supervising and guiding the development of the market by providing some sort of rating or certification of ownership and also to prevent fraudulent practices. Storage of art is a challenge because they require controlled levels of light, humidity and temperature. Further, thin and opaque markets make it easy for the insiders to artificially inflate the prices. For instance, price fixing collusion by two major auction houses in 2000, Sotheby's and Christie's, defrauded art investors by million of dollars. The method is similar to stock market manipulations by the major stock brokers.

Art is a good investment, but only in the long run. Its gain has been slow, but steady. It is a good investment because people of taste recognize their historical significance and their rarity. These are values that no other investment options offer. Art is certainly growing as an asset class. The number of art advisory firms promising to help new art market entrants is growing. Many financial institutions are building up large databases covering various segments of the art market. A few firms are also seeking the advice of art experts to build art portfolios for their wealthy clients. But it is never going to be just about numbers. Art speaks a language-subjective and unique. Most people, who have made money over the years, haven't bought art as an investment. Nearly everyone, from art experts to gallery owners to financial advisers, emphasize that investment should never be the sole-or even the primary reason to buy art. The art market has been in existence for a long time because of its returns-capital gains, pleasure and social status. Considering that art touches a personal chord, it can never be a staple part of institutional investment portfolio.

PRECAUTIONS PRIOR TO INVESTING IN ART

Before investing in any artwork it is important to have some knowledge about art trends, promising artist and their market value. Paintings by new artists are likely to be priced within the reach of more buyers. On the other hand, senior and well established artist command a high market value. Art can appreciate almost 100 percent if an artist gets a positive response to a show with huge sales. Thus, one needs to assemble all the data and come to a decision based on facts.

Points that one should consider when zeroing in on an artist are:-

- The credentials of the gallery representing him: A tie up with a good and established gallery with a national and international presence is a must. It ensures that the artist is promoted and represented well in the domestic market as well as abroad.

- International exposure: Participation by the artist in international exhibitions, art fairs and other major art events ensures that artist has sufficient worldwide exposure and the investor has an opportunity to view feedback on how his works have been received.

- Price curve and history: A record of the artist's price as it evolved over the years- is a good marker regarding the trend. One needs to check the artist's price at previous auctions. It cannot be a benchmark, but it is fairly indicative.

Some of the basic rules which need to be followed while investing in art are:

- Investors need a reputable dealer who has been in the business for many years-long enough to know about the quality, market trends and pricing practices in the field.

- Obtain a written appraisal or certificate from a lending appraiser or certifier who can attest the authencity of the item.
- Insure the item adequately. The paintings need to be insured properly in the event of theft or fire.
- Maintain the artwork properly: If the repairs are required, they should be made only by well trained experts. The value of a poorly maintained artwork diminishes rapidly.

Avoid putting more than 10-15 percent of the value of investment portfolio in such investments Asset pyramid must have traditional investments such as equity and debt nearer the base and alternative investments closer to the apex. Also, investing directly in art has its own drawbacks. These artworks need to be protected against theft and damage. One needs to have large sums of money to buy these works. Also they occupy a lot of space so storage is an issue that needs attention. So for all these who are willing to invest in art but have money and space constraints, there are art funds available where one can pool the money along with other investors and invest in art.

Art funds are investment vehicles that, like hedge funds and private equity funds, exist to provide substantial commercial rewards to two categories of people or institutions -

- ethose who provide the capital that allows acquisition of the art.
- those who manage the fund.

Artworks of an artist are difficult to quantify in terms of money because it has more of emotional value and it contributes to the cultural heritage of a country. Fund houses on the other hand are about money. Their objective is to maximize returns for investors just like a portfolio manager of any other fund. Fund houses do not hold these art pieces for infinite time period. The holding period determines the balance between:

- pressure by investors for returns earned on their investment
- Fee charged on the maintenance of portfolio
- Timing of entry or exit into a particular art piece.

These funds keep on selling and buying works of art during the entire life of the fund. Proceeds obtained from the sale of such works are used to buy new pieces with good potential for appreciation. The most established is The Fine Art Fund, launched in 2003 in London, and since then ARTESTATE, Sociėtė General Asset Management, and, more recently, the Art Trading Fund have all raised sufficient capital to provide investors with indirect investments in the art market. There is also a move towards more specialized funds that focus on one or two markets, such as Indian Art, Chinese art, or Contemporary artists. Some reputed art funds operating in

India are Osian's Yatra and Indian Fine Art Fund. Indian Fine Art Fund is a 5 year close ended fund with a minimum investment of Rs. 40 lakh. It is established by Philip Hoffman, who set up the fine art fund group, based in UK. It allows Indians, both resident and non resident Indians to invest in Indian art.

These art funds sell units like any other mutual funds and can be bought with transactions which are the same as the transactions for stocks. On buying, the units get listed as part of investor's portfolio and on selling them, these units are debited from investor's account. Some funds also have a lock in period during which investors cannot trade their units. Their NAVs can also be tracked on any NSE terminal in India. The strategy adopted by these funds is to identify piece of work which are undervalued and sell them at a higher price. The following Table II shows the comparison of returns of Osian's Art fund with other indices:-

Table II: Performance of Osian's Art Fund vis-à-vis other indices

Date	Osian's Art Fund	ET Art Fund*	BSE Sensex**	Debt Fund***
Jul-06	100.00	2616	10510	25.08
Aug-06	101.15	3276	11145	25.23
Sep-06	104.05	3065	11919	25.46
Oct-06	109.06	2989	12366	25.66
Nov-06	112.02	3137	13137	25.83
Dec-06	113.28	2565	13800	26.13
Jan-07	116.78	2998	13566	26.08
Feb-07	121.15	3026	14539	26.08
Mar-07	124.42	2778	12885	25.98
Apr-07	125.66	2781	13178	26.08
CAGR (%) Rp	35.56	8.5	34.88	5.24
Std Dev	9.29	8.79	11.75	1.52
Rf ****	7.48	7.48	7.48	7.48
Sharpe Ratio	3.02	0.12	2.33	(1.47)

Data Source:
** ET Art Index: Powered by Osian's featured in Economic Times (www. intelligence.com)*
*** BSE Sensex (www.bseindia.com)*
**** Debt Fund: Average NAV of Top 3 Long Term Income Funds (www.moneycontrol .com; www.mutualfundsindia.com)*
***** Risk free return: 91 day T-bill as on 9 Feb 07 (www.rbi.org.in)*

Sharpe ratio is a ratio developed by Nobel laureate William F Sharpe to measure the risk adjusted performance. It is calculated by subtracting the risk free rate (Rf) from the rate of return for a portfolio (Rp) and dividing the result by standard deviation of the portfolio returns. The Sharpe ratio explains whether the returns of a portfolio due to smart investment decisions or a result of excess risk. This measurement is very useful because although one portfolio or fund can reap higher returns than is peers, it is only a good investment if those higher returns do not come with too much additional risk. The greater a portfolio's Sharpe ratio, the better its risk adjusted performance has been. The Osian's Art Fund Scheme Contemporary 1 was launched in July 2006. Since then, based on a comparative performance with other benchmark indices in the market, the Osian's Art fund has not only shown the best returns, but has done so with minimum volatility. Compared to the ET Art Index and BSE Sensex which has seen tumultuous ups and downs in the past nine months, the Osian's Art Fund has seen a steady CAGR in the band of 32-40 percent. The Sharpe ratio is a clear indicator of the risk adjusted returns, which measures not only the CAGR of the asset class, but also takes into account the volatility of the asset class measured through standard deviation. As is apparent, the Osian's Art Fund has outperformed in the period of nine months as depicted through the Sharpe ratio. The long term strategy of the fund remains to add to the investor portfolio a stable asset delivering relatively high rates of return which can perform consistently over a long tenure.

SUMMARY AND CONCLUSION

Faced with underperforming portfolios, investors are continually seeking alternative assets and sophisticated solutions to reap high returns while minimizing risk. Art is increasingly being viewed by investors as an investment option. The gestation period is generally long. There are no cash dividends but only capital gains when one sells artwork. According to a survey by Merrill Lynch and Capgemini, art forms 9 percent of the total portfolio of high net worth individuals in the year 2010. Also art retains its value even in downturn as compared to other financial assets. When an investor buys the work of renowned artist then the risk associated with it is low. Unlike, when investor puts money in new and upcoming artists where the potential for appreciation in the long run may be high along with high risk quotient.This previously non transparent market is becoming more accessible via the increasing availability of indices and data on the art market. Additionally, art funds offer investors the opportunity to invest indirectly into the art market. Indirect investment into the art market results in losing the aesthetic pleasure from holding the art; however, financial gains can be made through pooling resources with the help of experts, while benefitting from diversification. The art fund market is still in its infancy. There are few alternatives and the minimum investment is quite high. In this perspective it can be said that for this investment to become a component in the portfolio of retail investor, accessibility as well as transparency needs to be increased manifolds. Also some amount of regulations needs to be imposed to protect the interests of investors and to prevent fraudulent practices.

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