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The Art of Investing in Art

by Kit R. Roane Jun 27 2007
Hedge funds turn to art as another asset to be arbitraged and flipped. Promises of significant profit potential are offset by some sobering precautions.

Sotheby's auction of Mark Rothko's *White Center (Yellow, Pink and Lavender on Rose)*, left, in May.

Wealthy investors looking for a reprieve from recent volatility in stocks and bonds will soon have a sophisticated way to play the art market, even if they can't tell a Rubens from a sandwich.

All they need is money to burn—about $200,000 minimum—and a taste for new risk.

With cold calculation, Artistic Investment Advisers, a British money-management firm, has set a July 1 launch for what is being billed as the first hedge fund to trade art like a commodity and to offer a hedge if the market goes south.

The Art Trading Fund, which says it has attracted about $40 million from investors, is among a growing number of new investment vehicles trying to harness investor interest in assets not subject to the vagaries of the stock or bond markets. It is also a testament to the financial world's ability to commoditize, securitize, and trade just about anything.

In addition to those focusing on art, hedge funds tracking the market for vintage wine and rare violins have cropped up recently, while Wall Street traders have been making sport of arbitrage on everything from fine watches to duck decoys.

"The people of Wall Street are setting a new trend," says Denis Gardarin, director of the Sean Kelly Gallery, which represents contemporary artists, in New York City. He adds that the rise in some auction prices has been propelled by a new focus on investment returns and the desire among some investors to show off both their money and their power.

"There is this exhibitionist sort of behavior now," he says. "How you are supposed to collect and what you collect is being shaken by this."

Driven by the same global liquidity that has fueled a buyout boom, prices for many contemporary artworks have skyrocketed in recent years.

This May, for instance, Sotheby's auctioned off Mark Rothko's *White Center (Yellow, Pink and Lavender on Rose)* for $72.8 million. (The seller, David Rockefeller, bought the painting for $10,000 in 1960.)

The sale price was about $30 million more than was expected and the highest price ever paid at auction for a contemporary work. By comparison, Rothko's *Homage to Matisse* fetched only $22.41 million two years ago.

The Mei Moses Fine Art Index, which tracks global art auction sales, showed returns of more than 18 percent last year, beating out the S&P 500 Index by more than 2 percentage points. According to Beautiful Asset Advisors, which produces the fine art index, annual returns on art auction sales have also bested stocks over the past five- and 10-year periods.

That has caused a lot of people to divorce art from meaning, says Mitchell Moss, director of the Taub Urban Research Center at New York University. "The art of collecting has turned into the science of investing," he says. "Art has now gone from being something you hang on the wall, that you collect, to being an annuity."

Artistic Investment Advisers is firmly in the annuity camp. In fact, its backers couldn't care less if art forced people, as Jackson Pollock put it, to come "face to face" with themselves, unless that reflection revealed some riches too.

"I am not really interested in art," says Justin Williams, an art collector and a director of Artistic Investment Advisers. "It is simply a commodity, which, when plugged into our business model, produces substantial returns for investors."

One of his partners, Chris Carlson, adds that he has no idea what makes good art. "I am not an art critic," he says.

What Williams and Carlson, a former trader at Deutsche Bank and UBS, say they do know—and know well—is how to profit from an inefficient market, even when it is not

rising. They say they intend to do this by exploiting the geographical arbitrage that exists between what buyers and sellers in different cities and countries are willing to pay, by picking up pieces during distress sales, and by buying directly from a select group of artists.

Williams says the fund will focus on Impressionist, Post-Impressionist, Modern, and contemporary art and that it will deal only with artists who have substantive and verifiable track records. He adds that the fund has little interest in "finding the next ‘great' artist" and that the fund will rapidly trade the art it buys through prearranged exit strategies, often selling pieces within a few months of a purchase.

"All our trades have at least three exit opportunities attached," says Williams. "We go for the exit with the quickest and best margin of return."

Based on audited performance of the art trading done by the company privately over the last three years, Williams says the fund should make 30 percent net returns annually. Its hedge, he adds, is basically a bet against 10 to 15 securities tied to the art market that should protect investors from any catastrophic drop.

Both the quick trading and the fund's hedging may come in handy. Although art has been a good investment over certain discrete periods, Merrill Lynch research indicates that it is one of the few assets where the probability of losing money remains high even for long-term investors, while also noting that art provides "inferior returns while generating substantially more risk."

The risks to the art market seem to grow more ominous every day if the past is any judge. The art market appreciated in the mid-1980s, with Impressionists and old masters (including Peter Paul Rubens) ringing up record sales to real-estate-rich Japanese investors.

The top of that market can be timed to the 1990 sale of Vincent van Gogh's *Portrait of Dr. Gachet* to Japanese industrialist Ryoei Saito. The chairman of Daishowa Paper Manufacturing, Saito paid $82.5 million for the painting, then was ensnared in a bribery scandal, went broke, and died. The painting, incidentally, never resurfaced.

It could be that the portrait's current owners are still waiting to get their money out of it, as art prices followed Saito's fortunes, tumbling 36 percent in 1991 and entering a near decade-long bear market. Many of the old masters and Impressionist works that led the market failed to recover.

That said, the Art Trading Fund might not be the best vehicle to profit from a rising market either. The fund will carry hefty fees—a 2 percent annual management fee and a

20 percent charge on investment performance—and rapidly buying and selling the art will drive up transaction costs, especially since auction houses and dealers already lard the process with fees of their own.

Nor will such a fund be an easy sell in alternative investment circles. Institutional investors, for example, would probably have trouble slipping this type of fund through their investment committees.

In addition, many investment advisers would worry about putting clients' money in something they themselves have a hard time understanding.

"This certainly qualifies as an alternative investment," says Joseph Aaron, of Wood, Hat & Silver LLC, a San Francisco firm that invests in hedge funds for individuals and institutions. "But I suspect it is a tad too alternative for traditional portfolios."

Even art market players with experience in more traditional art investment funds are skeptical. William Pearlstein, a well-known art investor and art market lawyer with New York-based Golenbock Eiseman Assor Bell & Peskoe is among those who believe investors can still obtain top pieces of art that "will garner the esteem and praise of peers," while not breaking the bank.

Pearlstein is also an experienced hand at art investment funds, having been an investor in one that imploded last year. The fund, Fernwood Art Investments, was launched in 2005 with great fanfare. It was shuttered more quietly in 2006 amid charges of mismanagement, and it is now the subject of several investor lawsuits, including one joined by Pearlstein.

Although Pearlstein still believes in the concept of art investment funds, calling Fernwood "a good idea" that succumbed to "flawed execution and garden-variety human frailty," he is circumspect about the quick-trading and commoditization of art embraced by the Art Trading Fund.

"The art market isn't a stock market," he says. "People who buy art are generally collectors or connoisseurs of a particular kind and there aren't millions of them with a taste for a particular artist, so I'm not sure about this idea of slipping in and out of pieces. There is not a lot of liquidity short-term."

Of course, the Art Trading Fund could still become a roaring success for its principals if a few well-heeled investors buy into the idea. With so much money chasing returns, all it takes is "a narrow inch of the world to get comfortable with it," says Pearlstein, then it's off to the races.