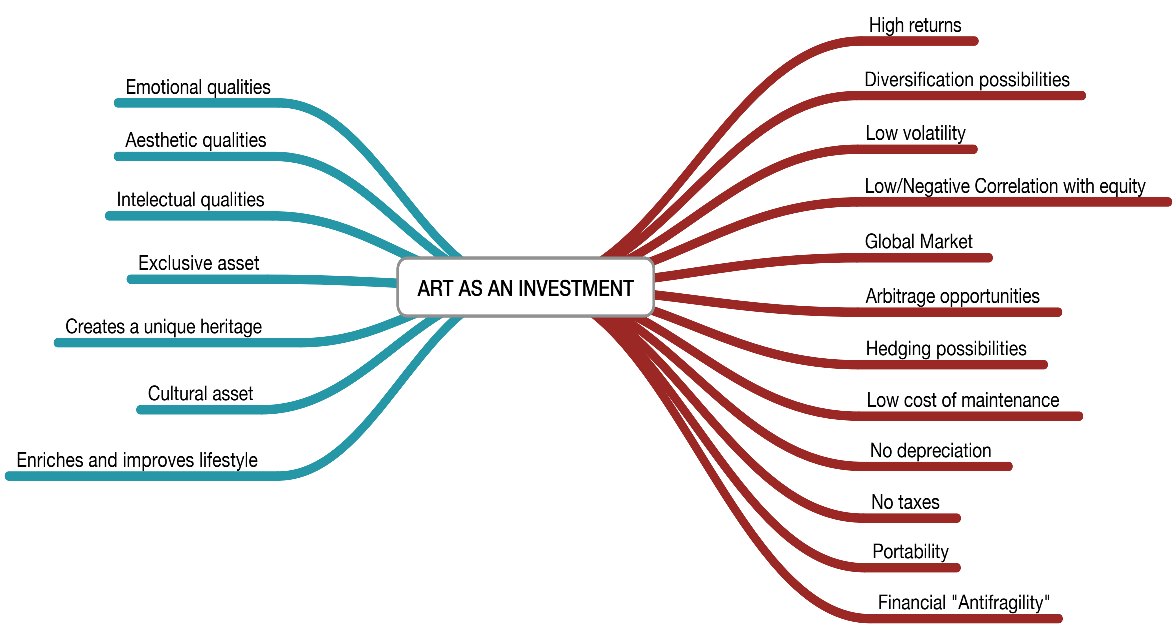
Securitization of Art as an Investment Vehicle

Why art?

What is behind the urgency that some have for collecting art? There are mainly five motivations present in anyone who dreams of being a collector: aesthetic taste, emotional motivation, intellectual motivation, the desire to create a legacy and lastly some financial consideration.

Art collecting is one of the principal reasons that artworks exist. It is the second-most important art activity, after the creation of art, and merits its own history. A penchant for collecting is closely associated with ownership and the personal projection of the individual through a work of art; it is a practice as old as history itself.

An investor's perspective on art collecting might be somehow different, for him art is a real and tangible asset that appreciates in value over time and helps diversify an investment portfolio. It is an asset that has proven to achieve attractive returns with low volatility, low costs of maintenance, no depreciation, hedging possibilities and low or negative correlation with traditional financial assets.

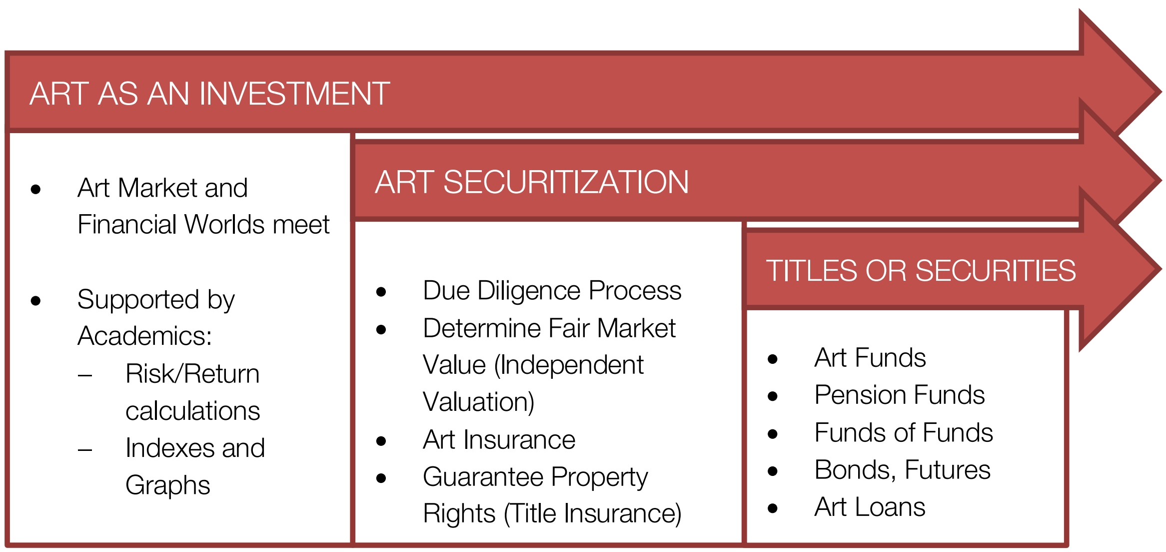


Therefore, art is an extraordinary and unique asset because it can combine in a perfect synergy these two visions without loosing its inherent esthetic qualities. Art is without question an emotional, cultural and financial investment.

Why securitization?

Although art collecting as an investment is a vision that has been carried out for centuries, it was until the last couple of decades that the financial sector has seriously approached the art world in order to diversify their investment instruments with pioneering and innovative vehicles. In response, an art investment industry was born and is developing to become an efficient and transparent industry that comprises the joint vision of wide variety of experts.

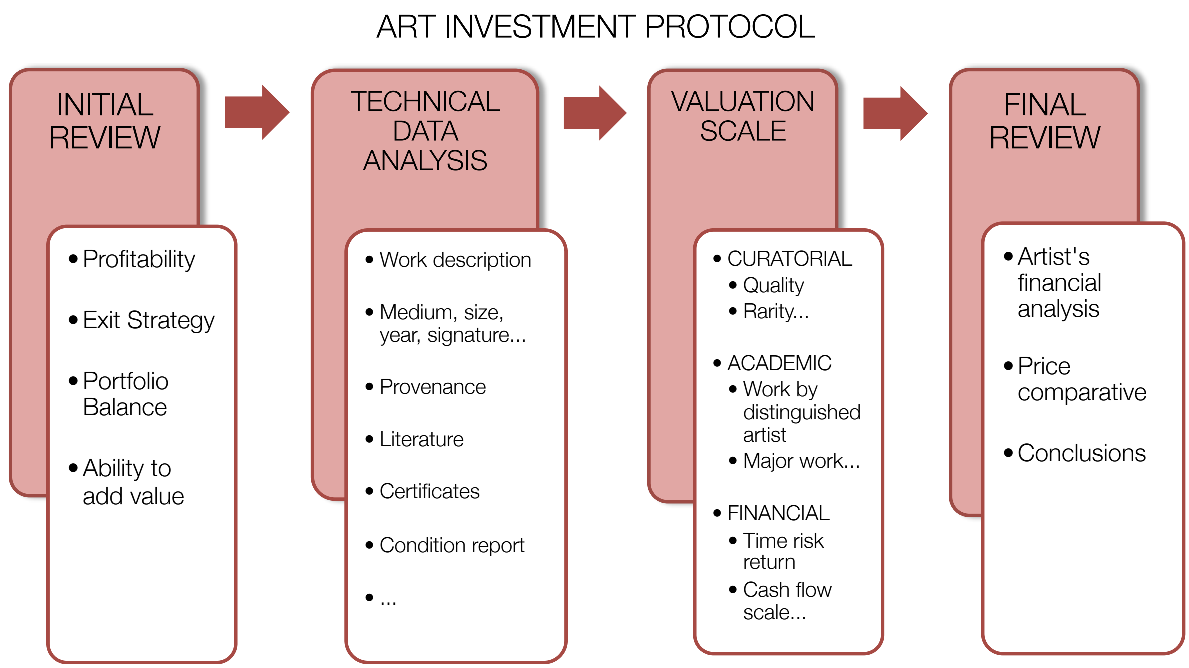
Securitization is the process by which the fund transforms an illiquid, passive or negative income producing asset into a structured and institutionalized financial product. For art, this process involves turning works of art into Titles or Securities without disrupting its intrinsic emotional components.



In order to transform art as an investment vehicle the first step is to acknowledge it as an investment asset. Numerous academics have devoted their research to prove in a scientific way how art is an attractive investment by measuring its returns and risks throughout different periods of time. As a result, these researches constitute the support, the backup and the infallible prove to several beliefs gained by experience or general knowledge from the art world. Thanks to them we have indexes, graphs and vast data that can demonstrate to the financial world how art can be a unique and profitable asset.

Once art has been accepted as an investable asset, financial advisors, asset managers or patrimonial planners to name a few, have tried to incorporate it in general investment portfolios as they would with any other asset, taking into consideration the risk-return tolerance and the investment horizon of each investor. Despite the week and fragile economy that has prevailed in the last years, art has overcome the turbulence and has gained significant attention from the financial sector.

The next natural step in the process is the birth of institutions devoted to investing in art like art funds, it is through them that artworks are transformed into titles or securities. This involves several processes and experts. To begin with, it is of the utmost importance to choose the correct artworks, for this a thorough and exhaustive due diligence examination must be performed. The works of art should be analyzed artistically and financially giving the same importance to both characteristics. Additional to all this process an external valuation is always needed in order to determine the Fair Market Value of the piece.



As important as choosing the correct artwork is assuring its property rights. It is known that the holder of an artwork is not necessarily the legal owner; this is a situation that could easily be avoided by the correct provenance investigation or by purchasing Title Insurance.

Once artworks have been transformed into Titles, countless financial instruments can be expected to appear, for example bonds or futures. An alternative way is that larger financial vehicles adopt them as part of their resources, like pension funds or funds of funds.

But why go through all of this process when it might be simpler just to invest in the stock market and collect art as separate things. While stocks can suffer double-digit losses in one day, the art market exhibits far more stability due to the limited supply of fine works of art and the emotional attachment collectors have on them. By securitizing art most of the investment risk is gone because the risk is absorbed by the entity issuing the title. Additionally, the resources needed to search for a good quality investment artwork are used more efficiently if they are pooled together in an organized and institutionalized way.

Inefficiencies in the process

The art market is not as transparent as other markets and is not regulated by any organism. Despite that this could be favorable to investors it creates several very important inefficiencies that make obstacles when securitizing art. For example, high transaction costs, illiquidity, high barriers of entry, very specialized markets, asymmetric information, limited offer and indivisibility of artworks. Nonetheless some of these market characteristics are what define art a unique investable asset. Art's illiquidity is somehow compensated with its price appreciation over time, meaning that the high returns achieved somehow include a premium for the illiquidity of the asset. Although artworks are indivisible, titles with art as the underlying asset are perfectly divisible, however the unhealthiest inefficiency is the unreasonable transaction costs.

Fees and premiums paid to intermediaries are the highest transaction cost (especially those from art auction houses), however Internet sales are changing the infrastructure of the market; in the last couple of years they have had a slow but steady growth. In the past, an auction house was an important location to connect a buyer and a seller. It was a place where accurate and real market prices were set. A seller was willing to pay a premium because there were limited means to reach buyers. But those days are gone; progress has finally caught up with the major art auction houses. The concept of selling art at auction houses is an anachronism that has been held up by the traditions of art sales supported by old forms and stodgy protocols.

The technology revolution is pretty much decimating every storied seller in every industry and the art auction houses are not immune to the revolution. It was inevitable. The auction house, a middleman that earns commissions that average 25 percent, has marked its own grave through its inefficiency. Just as fast the Internet destroyed newspapers, the auction houses soon will be relegated to a footnote in the annals of history where the list of businesses that have died due to poor business judgment grows larger by the second.

What to expect from the Art Investment Industry

In the art market the demand for good quality works will continue to grow at a larger rate than the offer, and thus prices will keep increasing. The demand will grow because every day more people are looking for a safe way to store their wealth in a diversified assortment of assets. Extraordinary record prices will continue to reach the news headlines because masterpieces will become scarcer in the market. All of this will allow the art investment industry to keep developing and evolving faster than we can imagine. Art investment vehicles will continue to thrive; they will become more institutionalized, regulated and sophisticated as they mature. However, it is inevitable that transaction costs diminish in order to make these instruments profitable and attractive for every type of investor.

From a collector's perspective, art investment vehicles will achieve credibility as long as they preserve and respect the innate emotional components of arts. As for investors, they will need assurance of art's investment qualities and its ability to become the underlying asset of an investment vehicle. In order for art investment institutions to succeed, the collectors' and investors' visions should merge into one. Art will become an institutionalized emotional, cultural and financial investment.