



## Due-Diligence Process for the Experienced Investor

Before investing in Art, a thorough due diligence must be performed in order to guarantee the viability of the investment. It is never really possible to guarantee that an investment will be profitable; however, the probabilities rise exponentially if the correct artwork is selected. Art investment funds have the ethical and financial responsibility to invest only in artworks that have been carefully chosen.

But how to decide when an artwork is investment grade and when not? Although usually the fund manager's experience is fundamental in the process, it is helpful to establish a systematic and structured way of analyzing each offered artwork. Weighting both artistic and financial qualities into the equation is of utmost importance in order to avoid making biased choices (1). Although the main objective of an art investment fund is to achieve attractive returns, analyzing statistical and financial data is not enough; the emotional and aesthetic qualities of the underlying asset should also be taken into consideration. In the end, there is no substitution for quality.

**1) THE OFFER:** Even before analyzing an artwork offered it is important to know who is offering the artwork in order to assess if it comes from a credible and reliable source. As institutionalized investors it is important to comply with strict Know Your Customer (KYC) protocol, this will minimize provenance, transaction and investment risk. It is also very useful to sign a formal letter of intent to protect both the offering and offer parties in a confidential way.

### **Due Diligence:**

- **About the Offer (KYC)**
- **Initial Review**
- **LOI**
- **Profitability Assessment**

**2) ARTWORK ANALYSIS:** Before thoroughly analyzing the investable qualities of an artwork it is essential to have all the basic data that describes it. Some of the fundamental information categories are: title, artist's name, year of work, media, size, signature, number of edition and location. We also look at aspects such as importance, relevance, quality or rarity. Without any of these it will be very hard if not impossible to accurately evaluate an offered artwork.

**Due Diligence: (Technical, Curatorial & Academic) lengthy proprietary process that includes among others obvious issues pertaining to:**

- **Authenticity**
- **Provenance**
- **Condition Report**
- **Literature and Exhibitions**
- **Academic Annotations**
- **Artistic and Aesthetical Importance**

**3) PRICE ANALYSIS:** How to set a fair price for an artwork and what price should an investment fund pay for an artwork? Apart from analyzing the quality of an artwork the price is determinant factor in solving whether it can be considered a profitable investment. The best way to determine the actual price of an artwork is by an external valuation to avoid impartial judgments. Given its institutional character an art investment fund should always have the ability to negotiate offered prices. By acquiring artworks at a discount price an automatic return can be guaranteed if it is placed again on the market.

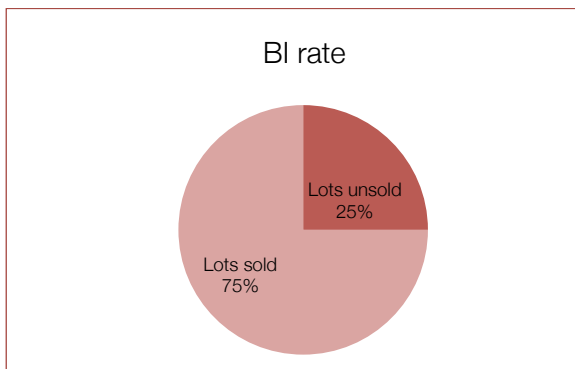
**Due Diligence:**

- Fair Market Value
- Internal Valuation
- Proprietary Valuation Scale
- Offered Priced in Relation to FMV
- Fund's Optimal Price Range

**4) FINANCIAL ANALYSIS:** How to measure an artist's track from a financial outlook? When considering art as an investment, as important as knowing the artist trajectory is evaluating its performance from a financial perspective. In the last decade, technology and academic research have facilitated the analysis of an artist's track record and made it comparable to other financial instruments. Although it is impossible to base an investment evaluation of art using only financial information it is very useful to support decisions in an institutional way.

**Due Diligence**

- Indexes
- Volatility
- BI rate
- Statistical indicators
- Ratios (i.e., sharpe & P/E)



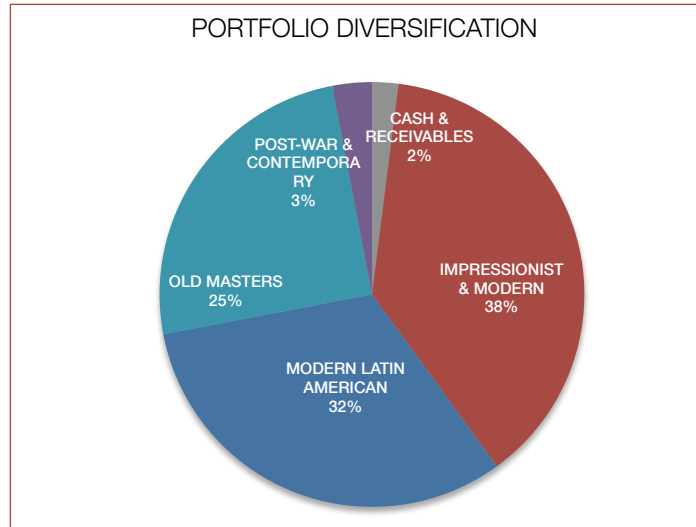
ARTIST'S STATISTICAL INDICATORS	
Average return (1999-2011)	31.4%
Average BI rate (1999-2011)	25.5%
Average transactions in a year	18
Sharpe ratio (return/risk)	0.365
Average PE ratio (price/estimated price)	1.13

**5) HOW DOES AN ARTWORK FIT INTO A FUND'S PORTFOLIO?** Although there are plenty of investable quality artworks, not all of them are adequate for an investment fund's portfolio. Even when the asset is the same, investing in art as a collector or as an institutional vehicle require very different approaches. Apart from thoroughly analyzing an artwork, an art fund must take into consideration additional aspects like portfolio diversification, ability to add value, etc.

**Due Diligence:**

- Diversification
- Share of Portfolio's Value
- Ability to Add Value

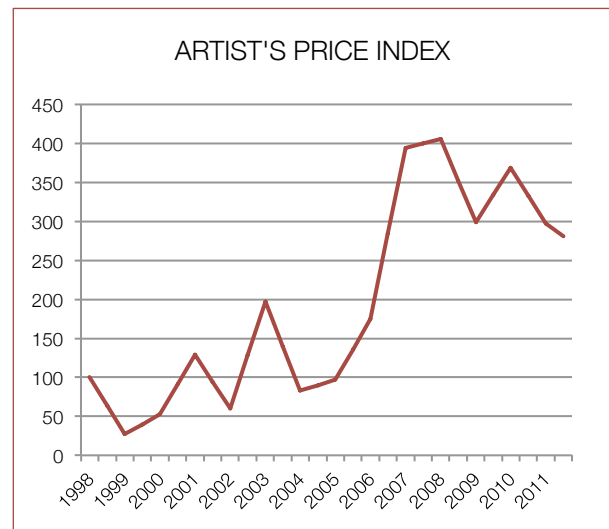
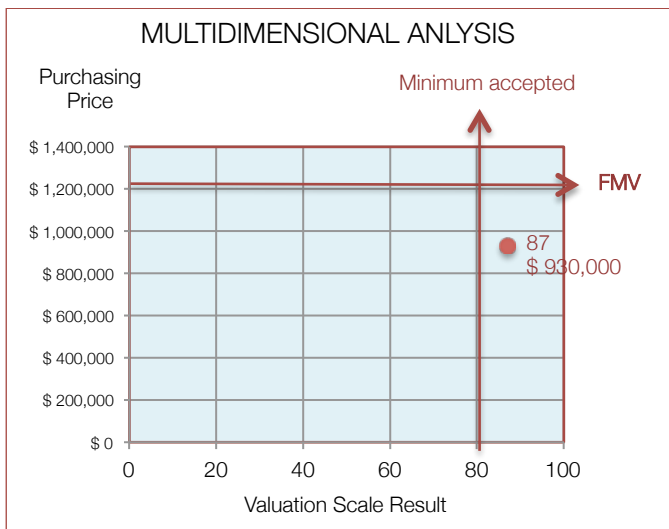
- **Efficient Administration of Liquidity**
- **Economies of Scale**



**6) EXIT STRATEGY:** Before investing in any artwork it is of utmost importance to forecast its exit strategy. Planning ahead can lower risk and avoid misguiding the investment portfolio. It is impossible to predict the optimal time and exit price, however they can be targeted according to the state of the market and the fund manager’s expertise.

**Due Diligence:**

- **Holding Period**
- **Expected Returns**
- **AGF Proprietary Multidimensional Analysis**





**7) TRANSACTION CONTRACTS:** It is essential that the proper buying and selling contracts back every transaction. Both when buying and selling an artwork it is necessary to legally transfer the property from one party to another in accordance with the jurisdiction that applies in full compliance with import/export regulations and duties of such jurisdictions. We rely on best-in-kind dealers or sellers reports, warranties and representations, their right of possession and ability to transfer title free and clear of any claims, charges, liens and encumbrances of any kind. The conditions of a sale must be clearly specified and approved by both interested parties.

**Due Diligence:**

- **Parties and Artwork's Information**
- **Payment Strategy**
- **Sellers Reports**
- **Sellers Representations and Warranties**

**8) INSURANCE:** There are many risks and uncertainties that we shall discuss in a subsequent article and ways to eliminate or significantly reduce them to an acceptable level. However it is impossible not to mention title and risk insurance. Title insurance protects against any claim over the art's property while risk insurance safeguards the artworks against casualties.

**Due Diligence:**

- **Title Insurance**
- **Risk Insurance**

**9) CONCLUSION, SUPPLEMENTS AND THIRD PARTY REPORTS:** Prior to a final conclusion it is important to have all of the necessary third party valuations and reports that give an unbiased opinion or recommendation about the artwork. They will serve as a general reference and support the fund's decision of acquiring or not an artwork offered.

A brief but accurate due diligence process should diminish the investment risk and help optimize the investment portfolio, offering confidence to investors and wealth managers alike. Additionally there is some added value to artworks that have been through a strict due diligence process because they have been thoroughly examined and evaluated. In certain way art funds bring trustworthiness to the market and can become credible sources of reference.