MANAGING ART INVESTMENT RISKS

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According to the last *Art & Finance Report* by Deloitte & Art Tactic, confidence in the Art Fund Industry is mixed. The report states: "The majority of art professionals and collectors believe the art fund industry will expand in the next 2-3 years, but wealth managers are still very cautious. Risks such as "Authenticity," "Title," "Investment," "Casualty," "Currency" and "Macroeconomic Risk or Uncertainty" are listed among top concerns of wealth managers and have kept the industry in the boutique investment sector. It is true that, as with any investment, the attractive returns of art come with considerable risks. The main question that this article intends to tackle, however, is how to properly manage such exposure.

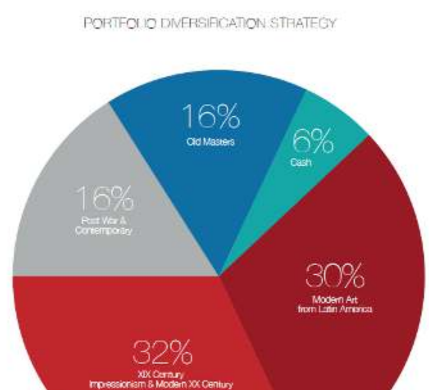
There is no doubt that the investment consulting industry, while still a newcomer to art as an asset class, has made important strides in recent years. We believe that the most relevant contribution has been recognizing and explaining to the investment community at large, with relatively good accuracy and under standard financial metrics -which allow comparative analysis to traditional investment products- the risks of investing in art. However, the identification and implementation of real-world solutions to such problems might better fall on professional art investment managers. *Artemundi Management Limited* (AML) believes that the recent and growing participation of mainstream consulting firms and private banks in the art investment industry can only serve to benefit the latter with more formality, which hopefully will bring in new investors. But the Artemundi Group has been facing these uncertainties as part of its art investment management practice on a daily basis for over 30 years. Based on the accumulated knowledge of five generations of art collectors and thousands of art transactions, AML regularly implements the pragmatic solutions of a hands-on player with direct involvement in the market, and legitimizes these practices by being a true day-to-day investor in art with "skin in the game."

Let us first take on the **risk of authenticity**. Needless to say, thorough due diligence on provenance, as well as stylistic and technical analysis by experts should be performed without exception. These measures however, may prove insufficient. Artemundi has pointed out before that the authentication of art is in a feeble state, particularly because there is no agreement on best practices, which naturally becomes more poignant in the case of conflict. Indeed, the absence of generally accepted norms, both in terms of authentication processes and governance authorities, can make the verification of genuine art extremely difficult. Experts at different levels have contributed different ideas. Recently, legislative initiatives in New York State to protect art authenticators against frivolous lawsuits for issuing opinions on authenticity have been welcome. Mr. Javier Lumbreras, CEO of AML, suggested the creation of an organism similar to the *Fédération Internationale des Véhicules Anciens* during his opening speech at the Authentication in Art Congress in The Hague in 2014, where he shared a few real-life experiences on conflicts involving authenticity from different angles. He repeatedly underlined that one of AML's best practices in reducing authenticity risk has been **creating consensus amongst the experts** involved.

Moving on to **title risk**, transparent and secure ownership is naturally vital to any market. Legal certainty is required, as in the case of any asset, for art to be considered a possession, determine its value and be commercialized. True ownership allows the holder to sell, donate, transfer, and/or enjoy an artwork. In the case of art more specifically, several factors aggravate the risk of title. "Title risks are defined as any withholdings, charges or burdens applicable to the putative possession –or property- of the artwork due to defective title [...] Defective title, in turn, may derive from historical/contemporary robbery, illegal import/export, unauthorized sale, creditor claims and bankruptcy [among other reasons]."[1] In the art world, provenance rarely is equivalent to legal title. **Title insurance** is used by most if not all, art market participants; buyers, sellers, dealers, auction houses, foundations, and moneylenders. While not a guarantee to legal title, the parties involved acquire property title insurance in their art transactions mainly to strengthen the operation and consummate the sale. According to the insurance policies, title risk is transferred to the issuer, who assumes the loss if the insured artwork is subject to a better legal claim by a third party.

Often cited as one of the overriding challenges for the development of the art fund industry, **the unregulated art market** is seen as a significant investment risk. "A total of 86% of the private banks and 77% of the family offices surveyed said this was the biggest challenge in dealing with art as an asset class […]."[2] But, is the art market really "unregulated"? Such assertion leads to somewhat of a historical quandary, because there are in fact **very old principles and conventions that have held the art market together for at least 200 years**.[3] Now, these same unwritten rules are seen as obstructing the efficiency of the art market. While the theoretical efforts of some institutions like the *Art Industry Forum* towards global scale regulations may be well intended, market imperfections not only prevail, but also make the market profitable to many with deeper insight on how it operates.

It can also be argued that the art market is not unregulated, but rather, self-regulated. We find this to be mostly true with art prices, where demand and supply forces achieve optimal prices by themselves, especially in private art transactions negotiated between buyers and sellers without the involvement of auction houses, galleries and/or dealers. We contend that **self-regulation** is for the most part, more important than specific legislation. Art intermediaries and their clients value reputation above all. While *de jure* rules may become necessary if the market evolves towards the participation of a much broader number of potentially ill-informed investors, it is **reputation** in the end that has been the most important *de facto* regulatory bastion in the art market. Reputation can be inspired by trust, but it is mostly acquired by repeated success in transactions and trustworthy assessments. The existence, *per se*, of art investment funds, speaks firmly in favor of the responsibility already afforded to such intermediaries in transforming the art market into a more trustworthy industry.



[1] Lumbreras, Javier*, The Art of Collecting Art,* Editorial Fomento Cultural Banamex, Barcelona, 2011, p. 200 (translation from Spanish)

[2] Picinati, Adriano Et al. *Art & Finance Report 2014,* Ed. Deloitte and Art Tactic, 2014. p. 67

[3] Please refer to Lumbreras, Javier, *The Art of Collecting Art*, Ed., Fomento Cultural Banamex, Barcelona, 2011, pages 83-102

To contend with **investment risk**, AML's strategy relies on, amongst other measures, **portfolio diversification** and proper **market analysis**. Art collectors see a benefit in art investment funds as a diversification tool, as a way of gaining broader exposure to the art market. A well-diversified art portfolio, covering works from the Renaissance to contemporary, generates an interesting risk-return balance. Each period has its own characteristics and a different investment profile. For instance, ancient painting has a slow but solid growth, while contemporary art might have a rapid but risky growth. In sum, funds apportion and reduce the risks of investing in art, unlike what occurs with an independent collector, by way of conforming a diversified portfolio. In making investments, Artemundi maintains a diversified portfolio to be held for long-term price appreciation, as well as a limited inventory for short-term trading. Proper market analysis also helps to significantly reduce investment risk through the power of expertise and knowledge. Better access to data and analysis has arisen as the art market increasingly looks for improved tools to make informed decisions. Some of the concerns expressed by wealth managers concerning the alleged lack of transparency and information in the art market are alleviated by online databases such as *Artprice.com* and *Artnet.com*, which provide information, for example, on average prices paid for artworks of a certain artist within a specific period, the volume of lots sold and all kinds of statistics.

Casualty risk remains a constant reminder of the real and tangible properties of art. New **art insurance** products are being developed occasionally to protect the investor against the risks associated with physical damage. It is indispensable, when assessing the value of a collection, to quantify the potential financial loss and its "replacement cost." Appropriate insurance coverage specialized in art is mandatory as a remedy to such loss. But it is also highly recommendable to prevent loss, by avoiding casualties, and in so doing, to be as efficient as possible. Experienced personnel for handling and packing are imperative for the logistics and transportation involving casualty risks. An ideal storage location with high security and proper climate conditions minimizes the costs of an insurance policy. It is convenient to store art in countries where political, social and economic stability prevails, like Switzerland, where various cities enjoy tax and customs clearance benefits and an open art market policy.[4] Keeping maintenance costs at minimum has been an essential efficiency strategy for AML, which average cost of maintaining, storing, and insuring one million USCy of art value per year has been estimated to be less than $2,000 USCy.

Investors' increasing global exposure makes **currency risk** a usual concern. Yet this kind of risk, while normally downplayed in the art market, is truly not quite as relevant, given the international nature of the latter. Any investor who holds stocks or bonds will have some exposure to a particular currency, and the quotation of the US Dollar will have an effect on these portfolios. But art, in fact, is a **good hedge against currency fluctuations**. The art market offers different currencies in which to operate. A global hub for business, the art market attracts sufficient local and international art buyers. The growth and global distribution of wealth and the rapidly increasing movement of art across borders are clearly correlated. Import and export statistics in the *Art & Finance Report* by Deloitte & Art Tactic

[4] Please refer to Lumbreras, Javier, *The Art of Collecting Art*, Ed., Fomento Cultural Banamex, Barcelona, 2011. p. 389

actually help to illustrate the rapid globalization of the market and underline the importance of the open trading regime of art.[5]

Finally, the investment consulting industry's negative appreciation of **macroeconomic risk** in the art market could well rely, mostly, on unfamiliarity and inexperience in the asset class. In order to have a better grasp of the challenges of investing in the global art market, a deep understanding of the asset itself is required. For purposes of example, we address herein two specific issues relating to the macroeconomic risk of investing in art: liquidity and transaction costs. The lack of liquidity of art, which is referred to as a major deterrent to more investment in the asset class by the investment consulting community, also favors art with stability and low correlation with the stock market. The **low volatility of art** was accurately demonstrated during the 2008 recession, when art indexes only dropped 4.5%, while the S&P 500 dropped approximately 37.5% (subsequently in 2010, the *All Art Index* grew to 22.6% and 10.2% in 2011, compared with the stock market's 9.1%). Also apparently inherent to art is the negative aspect of high transaction costs. In this respect, AML believes that success in the fine art market is achieved to a considerable degree by **maintaining transactional costs at a minimum**, (while keeping very low management and administrative costs) combined with the ability to identify and act upon opportunities with proper cash reserves in the portfolio. Aware of the high costs of operating through auction houses and galleries, the average commission AML paid out to intermediaries during the first *Artemundi Global Fund* was only 2% and more than 60% of the transactions paid no commission at all. This transactional efficiency is part of AML's axioms to superior profits.

Measures such as those described above and applied by AML signal that the direct players in the art market have been long aware of the investment risks that have, as of recent, begun to be pointed out by traditional financial consultants, and that such risks have been managed before to a good degree. Professional art investment managers such as AML consider art a stable asset with the capacity to outperform traditional stocks and banking investments, sometimes even in the short and medium terms. Actions speak louder than words, and in spite of their criticism, the growing interest of mainstream asset managers, consulting firms, private banks and wealth managers in entering the art market through partnerships with art investment managers should be the most convincing argument in favor of art as a legitimate asset class.

[5] Please refer to Picinati, Adriano Et al. *Art & Finance Report 2014,* Ed. Deloitte and Art Tactic, 2014. P. 14.