

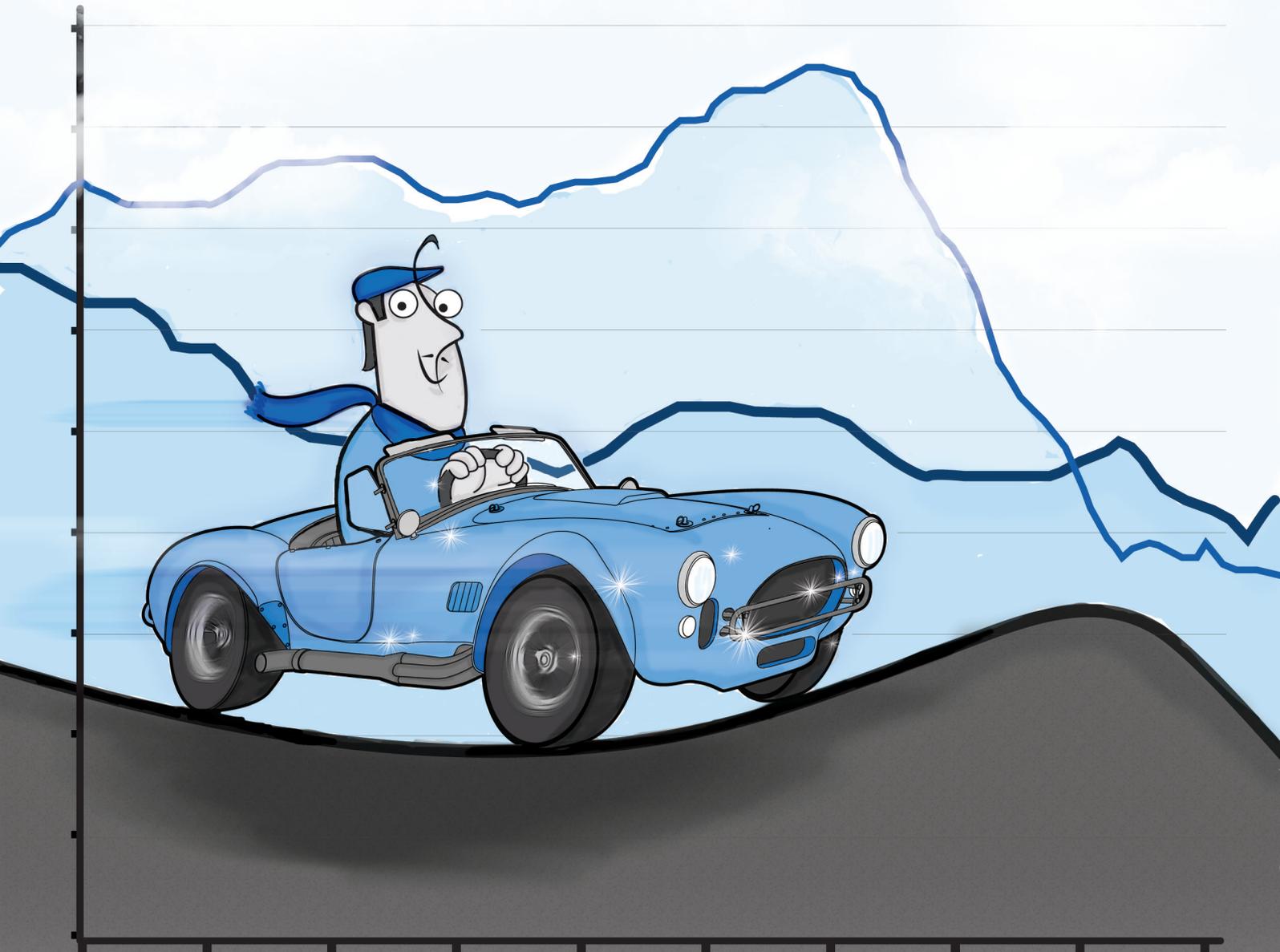
Volume 21 //

Acuity

The greatest wealth is **your peace of mind...**



Are collectables an unbeatable investment?



‘Sometimes your best investments are the ones you don’t make.’

Donald Trump, property tycoon

The trappings of wealth such as beautiful art, fine wine, classic cars and old watches – otherwise known as ‘collectables’ – may have an aesthetic value, but how do they fare as investments? This volume of Acuity provides a quick look at collectables in an unemotional light, and asks the question: are their allure and headline grabbing returns a marker of a good investment opportunity, or should you only own them if you enjoy them?

Collectables as investments

Everyone has heard the stories about vast profits made on collectables, from classic cars to bottles of vintage ‘first growth’ Bordeaux wines. Take Jon Hunt, the founder of Foxton’s Estate Agency, who sold the company at the height of the pre-credit crisis housing boom, and bought a Ferrari GTO 250 for an eye watering £15.7 million. He sold it three years later for £20.2 million. Not a bad return for a depreciating asset sitting in a garage!

Substitute the car for a Penny Black, Van Gogh, Patek Philippe watch, or a Stradivarius and the stories are much the same. Recent headline-grabbing profits have inevitably increased investor focus and appetite for real, collectable assets such as fine wine, coins, musical instruments, art, watches and classic cars to name a few. With this interest inevitably comes a spate of new investment products cashing in on the trend. The question that investors need to ask themselves is whether, in practice, these collectables represent a real and accessible investment opportunity that compliments a traditional investment portfolio, or not.

From sandwiches to investment strategy

The origin of investing in collectables on purely financial, rather than aesthetic grounds, is to be found in the most unlikely place: the old British Rail Pension Fund (Railpen). Whilst British Rail in the 1970s was stuck in the past, offering up a grim service of old rolling stock, run-down Victorian stations and dried up ham sandwiches, Railpen was well ahead of its time. In 1974 it allocated around three percent of its assets (around £40 million) into 2,500 pieces of art, achieving an 11% compound return over the period to 1999¹. In comparison, the UK equity market delivered around 19% and cash 3%. By all accounts, a few key pieces of art drove the bulk of the returns.

By 2011, the collections of the top 14 art collectors alone were estimated to be worth more than US \$75 billion² and that is likely to be higher today. The top three artists by sales in 2014 to date are Andy Warhol (\$590 million), Picasso (\$560 million) and Gerhard Richter (\$170 million). One could be fooled into thinking that art must be a great investment. Yet, the stories of poor performance are less well documented, and the structure of the market is such that most transactions are never known. One instance of art being a truly awful investment was that of the Japanese businessman, Ryoei Saito, who bought Van Gogh’s ‘Portrait of Dr Gachet’ for \$82.5million in 1990 and later reportedly sold it for one eighth of its original value.

Getting behind the stories

It is easy to understand the superficial appeal of investing in collectables, either directly or through some sort of pooled funds. However, it is important to get behind the headlines of the money pages of the Sunday papers and kick the tyres on these investment opportunities a bit harder. Perhaps the first step is looking at broader 'industry' data sets rather than the anecdotal stories of success. Each of these collectables now has its own set of indices, tracking repeat transactions. Indices like the Mei Moses® World All Art Index, the HAGI Top Index of the 50 most valuable classic cars and the Liv-ex Fine Wine 500 Index, appear to provide some transparency and an indication of the risk and return characteristics for different genres of collectables. Statistics from these indices are often quoted in press articles suggesting that collectables have delivered strong returns that are uncorrelated to traditional assets like bonds and equities.

The Economist has created a composite 'Valuables Index', which is made up of these different indices, according to the weights they are estimated to be held by individuals³: 36% in fine art, 25% in classic cars, 17% coins, 10% wine and 6% stamps. They have also added an allocation of 6% split equally between violins and guitars. At first glance, they appear to have performed relatively well.

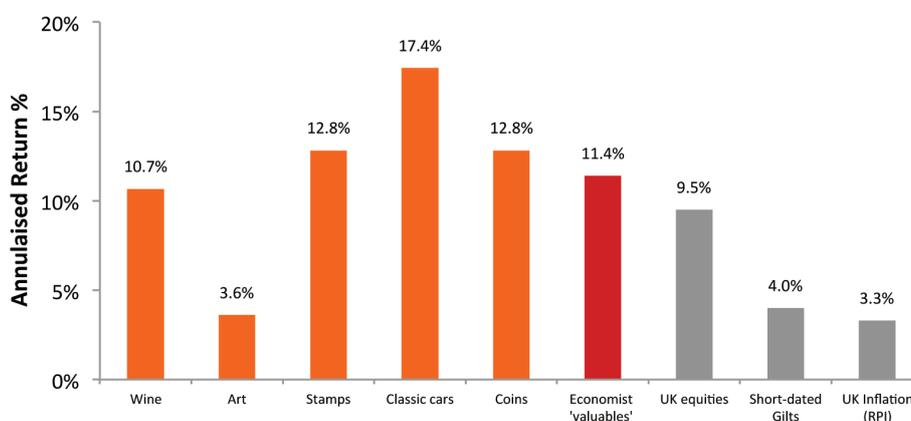


Figure 1: Index returns from collectable and traditional indices Q1 2003-Q3 2013

Data source: Collectables - The Economist⁴. Traditional assets – DFA Returns Program⁵

But the figures are misleading, as will become evident.

Sensible evaluation criteria – a framework for answering the question

The process for evaluating collectables is no different to evaluating any other asset class that is to be used in a portfolio. There are six fundamental questions that need to be asked and answered to an investor's satisfaction before an allocation can be made to it:

- **Source of returns:** where do the returns of the asset class come from and how robust are they likely to be in the future?
- **Data quality:** can the data be trusted and is it long enough to provide useful insight?
- **Portfolio role:** What positive contribution would the new asset class make to the existing portfolio?
- **Rewards:** are the risks adequately compensated for by the expected returns on offer?
- **Product structure:** do products exist that can capture the asset class return characteristics effectively?
- **Risk management:** can the risks inherent in the investment be effectively monitored and managed over time?

This evaluation process helps to shed light on the challenge that investing in collectables presents. If each question is answered with some thought, the superficial attraction wanes quickly.

Returns are driven by the global growth in wealth

Traditional investment assets can be valued by discounting back future cashflows into a present value.

Companies deliver earnings (and in most cases dividends) into the future. Bonds deliver coupon payments and return of principal. Investment property delivers rental income over time. All of these assets can be valued using their cash flows. Yet, collectables have no positive cash flows and in most cases deliver negative cash flows due to insurance and storage costs. That makes them hard to value by traditional investment valuation methods.

In practice, price movements are a simple case of supply and demand. Collectables tend to be illiquid, rare, often privately owned for both financial and aesthetic reasons, and non-fungible, which means that their supply is limited. Prices are therefore largely demand driven. It is evident that a small number of collectable items – often well-known pieces e.g. a Picasso, or brands such as Rolex – draw the attention of the very wealthy. Take the example of the one surviving 1856 one-cent Magenta stamp from British Guiana, which was sold at auction by Sotheby's in New York in June 2014 for £5.5 million, beating the previous world record for a stamp of £1.9 million. It had not been on the market since 1980, and was bought by an anonymous bidder. Perhaps it was the Queen, who is an avid philatelist with a highly valuable collection!

The demand is being driven by the very rapidly growing wealthy emerging from Russia, Japan and Asia, and particularly the Chinese who are very keen on collectables. The High Net Worth population in Asia – those with more than \$1 million of investable assets – grew from 3 million in 2009 to 4.3 million in 2013, representing an annual growth rate of 17%; and now enjoys a total wealth of \$14.2 trillion⁶, which is an awful lot of spending power chasing a few rare items. The consumption of wine is growing in China by 20% a year, and the Chinese have been large buyers of fine wines, pushing up prices. Tastes vary across nationalities, cultures and over time, which means that demand, and thus prices, will vary across different segments of the collectables market. The investment returns for collectables therefore depend on continued flows of funds and interest driven by growing wealth, the ability to identify trends in taste, and access to the rarest, most sought after items.

Data quality is poor

Despite widespread use of collectables indices, there is a major problem with the data. Most indices use repeat sales – the price between one sale and another – to estimate the change in prices of the asset class (or subsets of it) as a whole. Sales tend to be non-random, with pieces that have performed well or are in vogue coming onto the market more frequently than the bulk of art held by collectors. Many collectables are held and traded by private collectors and these prices are rarely visible and are thus not captured by the data. Many do not rise in value or go out of fashion, affecting prices, and the assets may simply hang on a wall, or sit in a cellar/safe/garage, creating a bias in the numbers. Transaction costs are rarely taken into account, yet for art sales these could be as high as 20-25%.

A recent piece of academic research⁷ reveals that, based on the art index under review (the Blouin Art Sales Index), the annualised return from 1972 to 2010 was in fact more like 6.5% per annum compared to the 10% reported by the index. Other academic research⁸, looking at the price of five long established Bordeaux wines – Haut-Brion, Lafite-Rothschild, Margaux, Latour and Mouton-Rothschild – from 1900 to 2012 revealed that these wines delivered a return of around 5.3% per annum above inflation and around 4.1% after storage and insurance costs, but suggested that these would be lower if transaction costs were taken into account. It also revealed that there was a positive correlation between wine prices and wealth creation, as indicated above. To place these returns from 1900 to 2012 in perspective, UK government bonds and UK equities delivered returns, after inflation, of around 1.3% and 5% per annum⁹.

Portfolio role is debatable

Collectables sit most definitely in the risk assets component of any investment portfolio as returns are likely to be highly volatile. For example, fine wines were flat against inflation for the first part of the twentieth century, went through a boom and bust around WW2 and have risen steadily since then⁶. As indicated above, the data set is poor quality which makes the understanding of the return and risk picture somewhat clouded. The correlation of prices to the growth in wealth, which is quite highly correlated to equity markets is, logically, likely to make them weak diversifiers of equity market risk. A lack of liquidity is not an endearing attribute in a portfolio asset.

Rewards appear inadequate

Leaving aside the extra layer of costs of owning a collective investment product to access assets, the returns of collectables probably sit somewhere between bonds and equities, taking account of the biases in the data and lack of transaction costs. As such, given that an allocation to collectables replaces an allocation to a diversified pool of equities, in the absence of any great diversification benefit, the case is hard to make for their inclusion. The summary conclusion of the research undertaken on the Blouin Art Sales Index is useful:

‘When we compared the investment returns and risk of all the styles of art to a portfolio of other assets, we found that art investments would not substantially improve the risk/return trade profile of a portfolio diversified among traditional asset classes such as stocks and bonds.’

Product structures are likely to be unregulated and costly

Remember that going out and buying a few cases of wine or a painting is a bit like picking a specific company’s stock. An investor may or may not get lucky. Even professional fund managers fail, in the main, to pick stocks that do better than the market after transaction costs and overtime. Will a fine wine manager do any better?

A collective investment approach, via a fund, intuitively makes more sense, but is not without its own material issues. Increased interest in collectables has spawned a rapid growth in art, fine wine and other asset class funds. Logic suggests that the costs of running such funds will be high as each piece needs to be identified, valued and purchased either privately or at auction. Transactions costs will be high. According to the Art Fund Association, art fund management fees range from 1%-3% per annum and they take 20% of the profit on any sale! Funds are also likely to be very illiquid, given the nature of the assets held, and lock-ins of five years or more are not unusual. Performance of the funds will be very dependent on the skills and trend picking abilities of the manager. Given that much of the money invested flows into well-known names and items, small funds may have problems accessing these areas of the market and diversifying their portfolios. The alternative - picking new emerging artists - is a highly risky business. Funds are likely to sit outside of the regulatory regime, i.e. unregulated collective investment schemes (UCIS), which are only available to sophisticated investors¹⁰ and carry materially higher operational and investment risks.

Ongoing risk management is challenging

Given that investors are likely to be operating in an unregulated environment and one in which many private transactions are likely to occur, the risk of fraud is far higher than that of a regulated OEIC or similar UCITs regulated product, investing in public market securities. Verifying the existence of assets, and monitoring their safekeeping, insurance and maintenance is no mean task. Reporting of interim performance for illiquid assets is also problematic, as is the risk of withdrawal demands from other investors. As a sobering thought, over 50 fine wine funds in the UK have been liquidated either due to fraud or 'colossal mismanagement' in the four years to 2012¹¹ and investor losses have been estimated at £100 million.

In conclusion

Sage advice in investing is often short and sweet. When it comes to collectables, investors would do well to remember the words of Donald Trump:

‘ Sometimes your best investments are the ones you don’t make. ’

Whilst it may seem disappointing that tangible, aesthetic items of historical interest and beauty - about which one can get quite passionate - may not, in practice, represent good investments, it is important to remember that good investing should be dispassionate and logical at all times.

By all means indulge your passion on a small scale. Drink it, gaze at it, wear it or throw the roof down, but don't think of collectables as financial investments that are contributing positively to you portfolio, unless you get lucky. Luck is not an investment strategy!

End notes

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Other notes and risk warnings

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