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Investing In Art For Love And Money

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Andrew Wyeth's 1948 painting 'Christina's World'*By Mary Campbell, Senior Reporter*

This spring, Steve Cohen of SAC Capital Advisors sold an Andy Warhol painting ("Liz #5") for a cool $27 million.

The deal wasn't one of the biggest sales of the past decade (it wasn't even the biggest sale involving Cohen¬—that title goes to a Willem de Kooning, "Woman III," for which Cohen is believed to have paid David Geffen $140 million in 2006) but it did serve to highlight the investment potential of art.

Past attempts to harness that potential through art funds have met mostly with failure, but in today's economic environment, says Enrique Liberman, investors are once again looking to art as a store of value. Liberman, who chairs the art law practice group at the law firm Tannenbaum Helpern Syracuse & Hirschtritt, is the president and chairman of the board of the Art Fund Association, a trade group for art funds. He told *FINalternatives* during a recent phone interview that "passion" funds are in:

"You're seeing the growth of what are now called 'passion' funds, which are investment funds that invest in basically, items of luxury and passion…So, you're seeing rare gem funds, fancy diamond funds, rare musical instrument funds, rare coin funds… any particular rare, luxury item that people will always want and of which there's a limited supply."

Art, he says, is one such luxury item, and funds focusing on art are part of what he terms the current "explosion" of passion funds. Getting a sense of the art fund landscape, however, is not easy. Says Liberman:

"Art funds are privately offered investment funds and, accordingly, they have to comply with the various restrictions on general solicitations of capital markets…There are a lot of art fund managers out there who are probably counseled by their attorneys [don't] open your mouth, don't give interviews, don't mention your fund and just go and solicit accredited investors with whom you have a pre-existing substantive relationship…"

ARTFA is in the process of creating an art fund registry, and Liberman says he knows of 25 existing funds and 12 in the process of launching. Most are offshore vehicles, although many of them, he says, have feeder funds for U.S. investors.

"I think that there's definitely a growing recognition of art as an alternative asset class; it's an established asset class…it can provide consistent, long-term, returns, it's an important inflationary hedge, especially when you're looking at the monetary policies of Western governments both here in the United States and in Europe."

The problem, he says, is that to attract the attention of the large banks and the high net worth individuals who can take art to the next level as an asset class, you need art funds with successful track records—and those are as rare as Ming vases and beardless Van Gogh self portraits.

But rare is not the same as non-existent.

One art fund with a track record is The Collectors Fund, founded by Sandy Kemper in 2007. Kemper was motivated in part by a love of art (his family is behind the Kemper Museum of Contemporary Art in Kansas City, Missouri) but as the founder and former CEO of Perfect Commerce, he is also aware of the business opportunity represented by art. Kemper says the fund's returns so far "have averaged over 30% per year. It's been a strong-performing fund. The asset class itself has also been a strong-performing asset class."

The Collectors Fund, which focuses on American masters of the 20th and 21st centuries, is structured like a private equity fund with a 10-year hold, although they buy and sell throughout the course of the 10 years, distributing cash from the profits of sales of the underlying assets.

Kemper himself is the single largest investor in the fund which he started with a group of friends. He told *FINalternatives* during a recent phone interview that what attracted him to the U.S. art sector, with its annual turnover of $7 to $12 billion, was that "it's a fairly inefficient market."

“One of the reasons we like it is that it’s uncorrelated, it’s superior in terms of financial performance, generally, and it’s a highly frictional market, so if you can…eliminate the friction that’s inherent in the traditional art marketplace or fine art purchases, then you can actually make some very good money in the discipline of buying.”

This “friction,” he says, can take a number of forms. At an auction house like Sotheby’s for example, buyers pay a “premium” and sellers a “commission” that varies depending on the country and the value of the item under the hammer.

Sotheby’s web site provides the following example:

“On a lot sold in New York for a hammer price of $1,500,000 USD, the buyer's premium would be 25% on the first 50,000 USD, 20% on the exceeding amount up to 1,000,000 USD, and 12% on the remaining 500,000 USD, for a total buyer's premium of 262,500 USD.”

“That’s an auction,” says Kemper, “there’s no ownership risk, it’s a 30% frictional cost…galleries can be equally frictional, and perhaps even more so. The cost of making acquisitions as an individual buyer if you don’t have any scale at galleries is sometimes as high as 50% of the total purchase price. So it’s a very inefficient market and yet it’s a market that’s large enough to have better efficiencies. It’s a market that has an asset class that is uncorrelated and does often perform better than other indices. So if you can bring scale, if you can bring purchasing efficiency, and if you have a fairly strong curatorial discipline and some degree of financial acumen, it’s a pretty interesting market.”

Rhea Papanicolaou, deputy director of global marketing and head of Southeastern Europe for The Fine Art Fund Group, agrees. The London-based art investment house founded in 2001 by Phillip Hoffman manages just over $100 million across six funds—three focused on Western art, one on Chinese art, one on Indian art and one on Middle Eastern Art.

The group’s first fund, The Fine Art Fund, is, like The Collectors Fund, structured like a 10-year private equity vehicle. It began investing in July 2004 and has generated an annualized return on assets sold of 33.5%.

“We typically use [it] as a benchmark,” Papanicolaou told *FINalternatives*. “It’s our oldest fund and it has the most significant track record…it indeed has had very positive results, and we’ve seen some very good sales results in 2010.” Last year, she says, was very much a seller’s market, with “people paying very high prices for works of excellent quality and rarity, so when something really good comes up there’s always demand for it.”

Papanicolaou echoes Kemper’s comments on the advantages of size in the art market:

“I’d say one of the secrets is that the art market is a very opaque market and the way we function, we’ve learned to reduce transaction costs to a minimum, that’s something most people cannot do that easily, so the strength of our team allows us to do that. We also have a negotiating power because we are a big player in the market and that is a plus.”

She also makes the case for “curatorial discipline”:

“The way we work, we have a team of about 30 top, top, top art experts who work as art buyers and art advisors to our funds… Those people work exclusively with us but are professionals in their own right, so they’re very established in the sectors they’re active in—either they have dealerships or they have galleries—and we basically partner with them on deals, they source deals for us.”

There’s also a “very long due diligence process” performed in-house before any acquisition, she says, and acquisitions are often made in partnership with some of the group’s advisors “to make sure our interests are aligned.” This, she says, is one of the secrets to the fund’s success, as is its geographical reach: “We have a very global presence,” says Papanicolaou, “our main offices are in London, but we do have partners and team members all over the world. We do the 10 most major auctions worldwide through this network and are very, very international in the way we work.”

Kemper says his fund looks for “things we like…things of quality.

“Our group focuses on American Masters of the 20th century, so we’re not looking for artists who are evolving, we’re looking for artists who are already in museums. And I think you can imagine, of course, that you’re going to sacrifice a little bit of the binary risk/reward scenario that you might find in other private equity or hedge-like instruments. We’re hedging, if you will, in the art market, by buying already established artists—the Franz Kleins, the Bentons, the Grant Woods, the Warhols, the Helen Frankenthalers.”

The Size Advantage

Both Kemper and Papanicolaou cite the advantages they enjoy thanks to the sheer size of their respective funds. Liberman reiterated this point, offering the example of a high net worth investor who decides to invest 2% to 5% of his $10 million portfolio in art. “That’s only $200,000 to $500,000,” he says. “With that amount of money, given where the art market is now, you really cannot acquire a diversified portfolio of fine art, it’s just not possible—you’d be lucky if you got one small Warhol, and not a good one.

“So, in that situation, what are you going to do? Well, the best course of action is to put the $200,000 to $500,000 into a fine art fund and then, in that case, you have a piece of a portfolio of 100-300 pieces, and you’re diversified, you’re protected against any kind of downside risk to any individual piece, to any individual artist, to any individual market—of course, that depends obviously on the investment strategy of the fund, but it gives you the right protections.”

Moreover, he says, a smart manager will spread his acquisition and research costs across those 100-300 pieces, which an individual investor with $200,000 to $500,000 to spend can't do.

"So," he says, "it's just the natural, most efficient way to get an exposure to this alternative asset market."

Valuing Art

One of the controversial elements of art as an investment is the question of how to measure the sector's performance. As both Kemper and Papanicolaou point out, the market is far from transparent—many sales are conducted privately—and the various indices used to measure performance all have methodological weaknesses. As Kevin Radell, writing in artnet put it, "The root of the problem lies in the heterogeneous nature of art market data."

Radell says that whereas all IBM common shares are alike and a price performance index can easily be generated for them, each artwork is different. Two Monet paintings of the same size, from the same period, even of the same subject can sell for wildly different prices, Radell explains, due to "the subjective interpretation of variables…such as condition, provenance, scarcity and rarity."

It's a difficulty the art market shares with the real estate market. In fact, when two New York University economic profs, Michael Moses and Jianping Mei, set out to design an index for art market activity, they used a statistical methodology similar to that developed for the residential real estate index published by Standard and Poor's. The Mei Moses All Art Index uses an approach called repeat sales regression, tracking price changes for individual art works that appear and sell at auction more than once.

Their database now includes over 13,000 repeat sale auction pairs and they add approximately 1,000 additional pairs each year. From this sample, they project a population estimate that suggests art as an asset class has performed about as well as stocks and better than other asset categories. The problem, of course, is that 13,000 sales are a drop in the bucket compared to the actual market—Radell, in his article, points out that the artnet Price Database includes records of almost 3 million auctions since 1985—besides which, many paintings are sold privately, far from the auction house sales room. Moreover, some works appear at auction but fail to sell, a fact not reflected in the Mei Moses index.

Liberman, while acknowledging the lack of price transparency in the art market, says a "properly structured art fund" can work around this. One way, he says, is to charge management fees based on capital commitments rather than the net asset value of the art.

Another is to lock investors in for the life of the fund rather than allowing them to come and go.
If you're a good manager, says Liberman, you'll raise the money, launch the fund and "keep your investors in" for five, seven, maybe as long as 10 years—"and then you sell the art and you give [the money] back to the investors. If you do that, the exact market valuation and where the market is at any one time, it's not as relevant necessarily to the operation of the fund."

A private equity structure, like that employed by both The Collectors Fund and The Fine Art Fund, is the way to go, says Liberman. "The funds that have chosen to run the more hedge-fund type model, they're the ones who have, generally, run into trouble."

Art Appreciation

It's also worth remembering that the rewards offered by an investment in art are not just monetary.

"I've been an investor [in] gas and oil and land, we all diversify, but what's pretty exciting about art if you do it right is that it can be aesthetically very rewarding as well," says Kemper.

For the 100 families currently invested in The Collectors Fund, that reward includes the ability to "borrow" some of the roughly 140 pieces in the fund's collection.

"…The art that we acquire…rotates into and out of our various homes and offices," says Kemper. "We have created, if you will, a private museum, without the infrastructure cost of a museum itself, and the art is in our members' homes and is owned by our members in aggregate. So we're able to enjoy the aesthetic and financial appreciation that's inherent in this asset class."

Not that Kemper has anything against museums, but, he says, it's also "pretty wonderful to bring the art into a member's home. I can see the art in a museum but it's a little bit distanced, it's a little antiseptic, I think art can be enjoyed so much more thoroughly in a home where you can sit in front of it for hours without someone coming between you and the art or moving you along..."

The Fine Art Fund allows members to borrow art (worth up to three times the value of their investment) from the fund in which they're invested. Papanicolaou says the feature is popular "but not tremendously popular." Some of their investors, she says, "have no knowledge whatsoever about art…they're just interested in our fund for the financial returns and for diversifying their portfolio." (This seems very much in keeping with the attitude of founder Hoffman who once told an interviewer he loathed much of the art he bought and that his fund takes "a very cold view" when making purchases.)

For those who do love art, though, Papanicolaou acknowledges the fund provides a wonderful opportunity:

"Our collection is comprised of some true masterpieces and our investors do have the option of borrowing some of those works and decorating their homes or offices."

Kemper, who borrows art regularly himself, cites a work by Andrew Wyeth as one he particularly enjoyed having in his own home, but says the overriding pleasure for him has been the ability to expose his children to great art.

“It really makes me feel like a good Dad,” he laughs.

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