# Art as An Alternative Investment

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With all the news about the sale of Edward Munch's "The Scream" at Sotheby's for nearly $120 Million on May 3, 2012, what was overlooked by many commentators is that Skates Art Market Notes for the May 2012 auction season lists ten pieces that are estimated to sell for $10 Million or more[1]. Many promoters are now rushing to flog direct investment in artwork, or investment in art funds, as a new "alternative investment". Also, it is increasingly likely that your clients will acquire tangible assets, or "treasure". Indeed, a recent Barclay's Wealth Insight Report showed that these treasure-assets are becoming a major percentage of the "mid-tier" client's wealth–-up to 10% in the U.S., and 20% globally.

So, is artwork and other tangible treasure an alternative investment? And if so, how should you get access to this asset class for your clients?

**Is art an alternative investment class?**

Art is an investment but it is a unique investment, especially in the modern art market. Much of the popular material on art investing is potentially misleading in its ebullient optimism. It can be hard to keep one's head in the face of popular literature extolling the giant winners in the game - Saatchi, Guggenheim, and their peers - creators of new collections, even new categories of Art, which dominate the market and return hundreds of times the initial investment. These giants are an integral part of the mystique of Art collecting, but a Saatchi comes along once in a lifetime.

Some art investments have, in fact, outperformed the stock market in the post- World War II years and, in many cases, quite handsomely. There have been periods when 25 percent compounded rates of return have been available to the investors; indeed, substantially higher rates have been achieved by many contemporary art collectors, and over long periods of time. But it is an economic impossibility to compound any substantial sum of money at a 25-percent rate of return indefinitely.

In order to consider suggesting artwork or other treasure as an investment for your clients, you need access to expertise and experience in the specific market[2]. The most critical expertise needed is in the areas of taxes, legal title, recognition, liquidity and premiums.

*Taxes*: Your client's income from transacting tangible assets is taxed differently than their investment or ordinary income. How your client handles the ownership of the collection will control the subsequent income tax treatment of their buying or selling tangible assets. The IRS recognizes four distinct types of taxpayer based on the role that the taxpayer plays prior to a transaction: Collector, Investor, Business Investor, and Dealer. Although the IRS will assume your client is a Collector (thus imposing the highest capital gains tax and allowing the fewest deductions), in reality your client may qualify for the more advantageous tax status of Investor, where more deductions are allowed as well as the use of techniques such as like kind exchanges. Qualifying as an Investor is not as simple as a declaration, and requires a well-documented pattern of behavior by your client; but a qualified expert can help your client position himself to obtain the most desirable tax status.

*Recognition*: The value of some of your client's collection will be much more susceptible to market forces than others. This may be because of the general standards of taste, critical acclaim, the vagaries of provenance and authenticity, the role the item plays in the culture, and changes in laws banning the sale or purchase of certain items. The collection needs to be aggregated in terms of what has the more stable pricing and what has more volatile pricing, questionable legality, or uncertain provenance.

*Legal Title*: Insuring that there is good legal title is critical for any investment, and doubly so for investments in Artwork. Today, claims for recovery of looted or stolen Artwork can be made from miles away and from deep in the past. Once there is a "cloud on the title" of artwork, there is essentially no time limit by which an alleged prior owner must submit a claim. Legal title to artwork is too often presumed to be clear in the mind of the current owner and advisor, and then when the piece is listed for sale or gifted to charity, the prospective buyer, the recipient institution, a trustee or fiduciary or a qualified intermediary (in the case of a reverse like-kind exchange, where this intermediate party must take and then transfer "clear" legal title of the asset in order to effect this tax strategy) have no guaranty of good title[3]. As part of the inventory process, your client should review those items for which the legal title cannot be adequately certified, and they should ob-

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tain title insurance, much as your client would obtain when buying or selling real estate.
*Liquidity*: The ease with which your client can sell an item also factors into aggregation. Rare, or unique, items by themselves may not be enough to provide liquidity: they must also be sought after by those willing to pay for the ownership and control of the item. A highly sought after item can easily be sold at auction or private sale even if poorly executed or heavily damaged, while a well-executed and flawless item may languish for months or years. In many cases, your clients will inherit a few highly liquid items and many illiquid items in the collection. By aggregating together the highly liquid items that your client wants to sell with the more illiquid items that also may need to be sold, you can give your clients leverage on negotiating fees, commissions and other costs on the sale.
*Premium*: Occasionally your client will inherit an item that they could only hope to own if they are willing to compete at auction with the most well-heeled collectors and institutions. These items can be key to the preservation of the rest of the collection, especially if planning has been done beforehand to allow for some of the estate tax avoidance in the settlement of the estate. These premium items are truly in a realm of their own, and require the most expert help in managing the preservation, transfer or sale.
Surprisingly, large single family offices rarely acquire this expertise. I recently spoke to the CEO of a single family office with assets in excess of $2 billion. The Founders of the family wealth are well known as collectors and philanthropists of arts organizations, but when I discussed what expertise or experience the Family Office had in managing or planning for the artwork owned by the Founders, the answer was, basically, "none". In the CEO's opinion, "you could go to a dozen other families of similar wealth and interests and the answer would be the same." These clients are not being poorly served as much as the needed bespoken service needed to invest in treasures does not fit the mass customization model of most large firms. However, a VHNW client will usually take no action unless and until a very highly trusted adviser recommends such a boutique firm to provide that collections management and investment service.
Art is an investment, but it requires very different expertise and experience to manage art as an alternative investment class. This expertise and experience is rarely found even in the largest single family offices, much less in the institutional investment management firms.

**How can my clients have access to Art as an alternative investment?**

**Direct Ownership of Artwork**

If you are offering the direct ownership of artwork as an alternative investment for your clients, you have to be one of three types of adviser: supporting, enabling, or collections adviser.

*The Supporting Adviser*: As a Supporting Adviser, your assistance to the client is limited to the execution of your client's specific direction as to what to do with the money when artwork is sold, from where to take the money when artwork is purchased, and keeping track of when artwork is donated. You may track the artwork on your client's balance sheet and financing the costs of acquiring and maintaining the collection. Expect, however, that your clients will look to you, as their trusted adviser, for a recommendation for outside expertise to either enable them to manage their collection, or expertise in actually acquiring and forming a new collection.

*The Oversight Adviser*: An Art Oversight Adviser is usually an independent consultant or a member of a boutique firm. They provide your clients with active help in sourcing how to finance the collection and provide access to types of tax strategies and collectible investment techniques, either through funds or through your client's direct ownership of treasures as investments. Usually these are professionals who also have a personal and professional interest and passion for art and other collectibles.

*The Collection Adviser*: A Collection Adviser provides the bespoken investment services of a niche collectibles firm, and all of the regulatory and specialized knowledge that implies, and they provide your clients direct advice on specific items, manage the outside expertise and experience, and bring their knowledge to bear on your client's collectible portfolio. Often these include access to independent curatorial staff, and work to actively manage and structure the collection.

**Indirect Ownership of Art**

If you wish to provide your clients with indirect ownership of artwork as an alternative investment, you have two choices. The first one is to invest in companies that profit from transactions involving artwork, for example Southebys[4]. The second one is to choose a hedge fund model, such as The Fine Art Fund Group[5] (for a good survey of the indirect investment in artwork, look at Skate Art Market Research[6]).

In either case, the necessary scale and expertise needed to play in the premium artwork market, which is where much of the profit is realized, is quite impressive. Southebys is by far the dominant player in the market which is publically traded. For a hedge fund, literally billions of dollars are needed to buy a diversified portfolio of artwork of the highest quality. Even then, Artwork Hedge Funds have the same issues any hedge fund has for individual investors. They are difficult to fit into an asset allocation model, the style of the managers is often opaque (since they are hoping to exploit the market inefficiency), the returns are under threat if the market inefficiency they exploit becomes too popular, and there is little you can do to negotiate fees or costs.

Finally, art funds lack one of the core attractions of investing in artwork and collectibles for your client: the value of direct ownership and control of the artwork involved. This alone makes many art hedge funds unattractive to individual investors.

**Conclusion**

High profile sales this Spring, as well as political and financial uncertainty, has many clients asking about art and other treasures as an alternative investment class. Many know the glamour stories of the returns over time, but art is even more of a challenge for an alternative investment manager, and their clients, over other alternative investment classes because of the very different key investment factors in the return on the art investment over time.

If you are not ready to become the Oversight or Collections Manager for your clients, then you need to seek out those who will. ■

[1] See http://skatepress.com/files/Skates_Art_Industry_Investment_Report_May_2012_English.pdf

[2] There are a number of firms that hold themselves out as experts in the area of artwork, such as the Winston Art Group.

[3] For more information on the complex question of legal title in the art and collectibles markets, which is at the center of all tangible personal property asset management strategies, see the information at www.aristitle.com.

[4] See http://www.sothebys.com/en.html

[5] See http://www.thefineartfund.com/

[6] See http://www.skatepress.com/