Art for investment's sake

Is investing in art a good long-term alternative in today's febrile investment climate? James Goodwin investigates

"THERE'S ONLY ONE INDICATOR FOR telling the value of paintings, and that is the saleroom," said Pierre-Auguste Renoir (1841-1919) the French Impressionist painter.

If artists can provide a deeper insight into our world, the themes of health, love, and even religion are among the foremost concerns of the ultra wealthy. These are the subjects occupying the top of the western post war and contemporary art market where average prices have risen nearly four times in just under two years, according to the Art Market Research index.

Among the main beneficiaries have been living artists. In June 2007, the British artist Damien Hirst's medicine chest, *Lullaby Spring*, fetched $19m (£10.5m) at Sotheby's in London making it the most expensive work by a living artist sold at auction. Less than six months later, the record was exceeded by the similarly youthful American Jeff Koons, whose *Hanging Heart* sold for $23.5m in New York. This May, both records were eclipsed by the $33m paid for 85-year-old Lucian Freud's (grandson of the psychoanalyst Sigmund Freud), 1995 painting *Benefits Supervisor Sleeping*.

This upward trend was recently put to the test again. In defiance of a dealer-led market system, which skillfully nurtures artists over long periods, on 15/16 September Damien Hirst offered 223 lots for sale, via Sotheby's in London, of his own new works with prices ranging from $30,000 to $23.6m. The sales exceeded expectations.

But do these works make good investments, particularly in today's febrile investment climate?

Art investment is beset by paradoxes. At worst, economists see it as a lacklustre and risky investment, and at best excellent. Art's uniqueness and the vagaries of taste give it a lasting, but also uncertain, value. Lack of market transparency and uneven supply, little or no income, and high transaction costs, resulting in low liquidity and long holding periods, have prevented art from developing into a conventional investment asset. Furthermore, the capital appreciation has to be much higher than most assets to make up for the cost of acquisition and disposal, valuation and provenance research fees, as well as tax, insurance, conservation and storage.

But there are downward pressures on costs, thanks to the wider availability of art on the internet and via online auction. Just under half of eBay's $59bn turnover in 2007 was art and collectibles, and auction house Christie's now supplements its auctions by offering most works online, resulting in a $2.6m bid for one item last year.

At best, the returns on art can be very respectable. Until 2004, the world's most expensive painting sold at auction – Picasso's *Garçon á la Pipe* sold for $104m giving its owners an average annual return of 14 per cent after costs. It was bought for $30,000 in 1950. More dramatically, at the contemporary art auctions in London in June 2006, 44 of the 697 lots measured by repeat sales returned an annual average of 13 per cent to their owners after costs, according to research by this author and Dr Rachel Campbell of Maastricht University.

And it is modern and contemporary art that is in the ascendancy. The antiques market (art more than 100 years old) has suffered, shrinking from a world market share of 24 per cent to 17 per cent in favour of 20th century modern, post war and contemporary art. Over half the top 200 collectors internationally collect post war and contemporary art above all art forms, according to *ARTnews* magazine. The world's second-oldest art dealer, Agnew's in Bond Street, London, whose 200-year-old history includes sales of the greatest old master paintings, is now emphasising contemporary art.

IT IS MODERN AND CONTEMPORARY ART THAT IS IN THE ASCENDANCY

So how do we value untested contemporary art from a new artist? In short, what's it worth? The answer is what the market, and by implication, society is prepared to pay for it. The value is derived from the prevailing aesthetic, cultural and social circumstances at the time of sale. This is based on a consensus among those working in the art market relying on knowledge submitted over many generations via dealers, auctioneers, critics and curators. When that changes, the value will change too.

Historically, upturns are more dramatic late in the economic cycle during periods of higher growth and inflation, while downturns occur about 18 months to two years after a major stock market fall, which signals a downturn in a major art buying economy. So there is a good chance that we might see a downturn in the western art market in the coming nine months or so.

Even more dramatic and prolonged falls occur with the passing of a generation of collectors, when fashions change and prices appear out of reach, and during periods of international trade protectionism. The Japanese-inspired art investment boom and bust of 1985-90 raised Impressionist prices to unrepeated levels and ushered in today's pricier modern and post war art. The breakdown of the free-trade system after the 1870s coincided with the demise of British contemporary art price levels following a 60-year golden age for living painters.

But that doesn't mean all art is a bad investment. It simply means you have to be more particular. Over three-quarters of art buyers see themselves as collectors rather than investors. This gives stability during economic downturns since art collectors take a long-term view of the market of up to 30 years. The downside is that supply is often constrained (supply to the art market is said to benefit from death, divorce and debt) leading to exaggerated rises and prolonged falls when investors disappear from the market.

YOU DON'T NEED TO BUY THE BEST

There is a common perception in the market that you should unstintingly buy the best you can afford. Not so. One of the foremost studies of art's returns by Professors Jianping Mei and Mike Moses of NYU, and others, using repeat sales for fine art auctioned in New York from 1875-2002 drew two conclusions that should appeal to potential art investors: the more you pay for art the lower the return; and the greater the diversification within an art portfolio, the greater the benefit.

Research, using all price methodologies, demonstrates that art's performance has a low correlation with other assets, and including it in a diversified portfolio produces a slightly greater return with less risk than stocks and bonds on their own. Several studies demonstrate that art is probably more closely correlated with the property market than other assets, which certainly doesn't bode well in the current housing downturn.

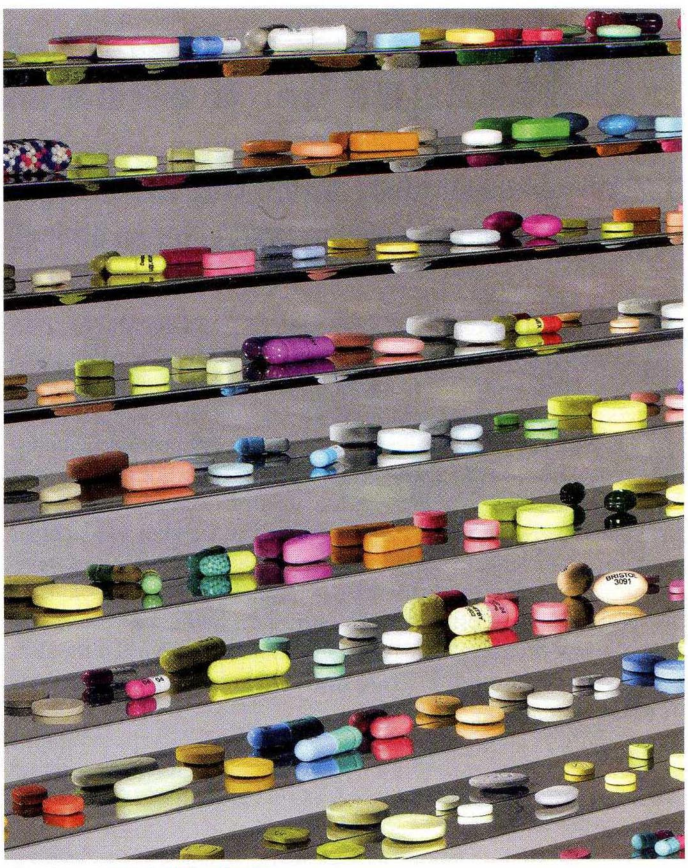
However, based on the Mei & Moses study, in 2005, the Barclays Equity/Gilt study, for the first time since 1956, recommended a portfolio weighting over the next 10-20 years of 10 per cent in art. In the last two decades, the further benefits of this type of diversification have been demonstrated by Latin American art, which offered a very high rate of return and a very low correlation to international equities and other art markets such as the US.

Another strategy, therefore, is to buy art for the long term from developing countries or 'undervalued' art in developed countries with good economic growth prospects.

This doesn't just mean the BRIC countries – Brazil, Russia, China, and India. Goldman Sachs recommends the N11 as general investment opportunities – (in order of projected income per capita in 2025) South Korea, Mexico, Turkey, Iran, Vietnam, Egypt, Indonesia, Philippines, Pakistan, Nigeria and Bangladesh. The major art auction houses are represented in five of these countries. As they reach a certain level of development, the wealthy proportion of the population tends to buy art, and very often indigenous art.

"BUY TODAY'S PAINTING: IT MAY GO UP. BUY YESTERDAY'S PAINTING: IT WON'T GO DOWN"

If you are a more defensively-minded investor, it's worth remembering the second part of the art market maxim: "Buy today's painting: it may go up. Buy yesterday's painting: it won't go down." Old master pictures, as well as decorative art, have usually performed better following economic setbacks. In 1991, when the art market last turned from the Impressionist-led boom to bust, the highest price paid was for an old master painting. The following year, 56 per cent of Sotheby's sales were for decorative art compared with 38 per cent during the 1990 boom.



Damien Hirst's *Lullaby Spring*

In recent years, one of London's best-performing art dealers, measured by return on capital, sells supposedly unfashionable antique English furniture.

In the end, though, you must buy what you like. If the financial markets falls about you and the value of your portfolio deteriorates, it is better to sit in your unsellable apartment with a painting you love, than a painting you regret buying.

James Goodwin, lecturer in the art market and commentator, is the author of The International Art Markets, published by Kogan Page (www.koganpage.com), 448 pages, hardback, £55. You can buy it for just £46.75 from the IC bookshop at www.investorschronicle.co.uk. James Goodwin can be contacted on arts.research@gmail.com.

WHAT ART INDICES TELL US

Charting the changes in value is not just a question of watching the auction prices. In fact, art indices can have a distorting effect on prices as auctions account for just half the art market. A study that compares dealer with auction prices by works from the same artists traded from 1974-2004 by Michael Hutter *et al* of Witten/Herdecke University indicates that dealer prices remain higher for longer during a downturn, but tend to track auction prices during an upturn. However, the indices are the only measure publicly and reliably available.

There are three types: average prices (such as that shown), repeat sales regression and hedonic regression. The average price method is based on a basket of art types or artists; repeat sale returns look at paintings sold more than once in the market; and hedonic regression analysis searches for, and quantifies, underlying forces behind art movements (income, inflation etc) or looks at interdependencies between the art and other factors (sale location, provenance, etc).