ARTBANC®

MARKET INTELLIGENCE

ISSUE 6

JANUARY 2014

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WHY BUY ART?

GREG B. DAVIES, BARCLAYS - WEALTH AND INVESTMENT MANAGEMENT

Art is increasingly being seen as an asset class in its own right. Media headlines paint a picture of a market that is safe, sensible, and open to a new wave of financially motivated investors ready to tap into a lucrative world that was once the preserve of enthusiasts and connoisseurs.

Such perceptions are inaccurate, and potentially dangerous if acted upon. The media attention given to the art world's most successful investment stories has built up the false perception that anyone can make money from art.

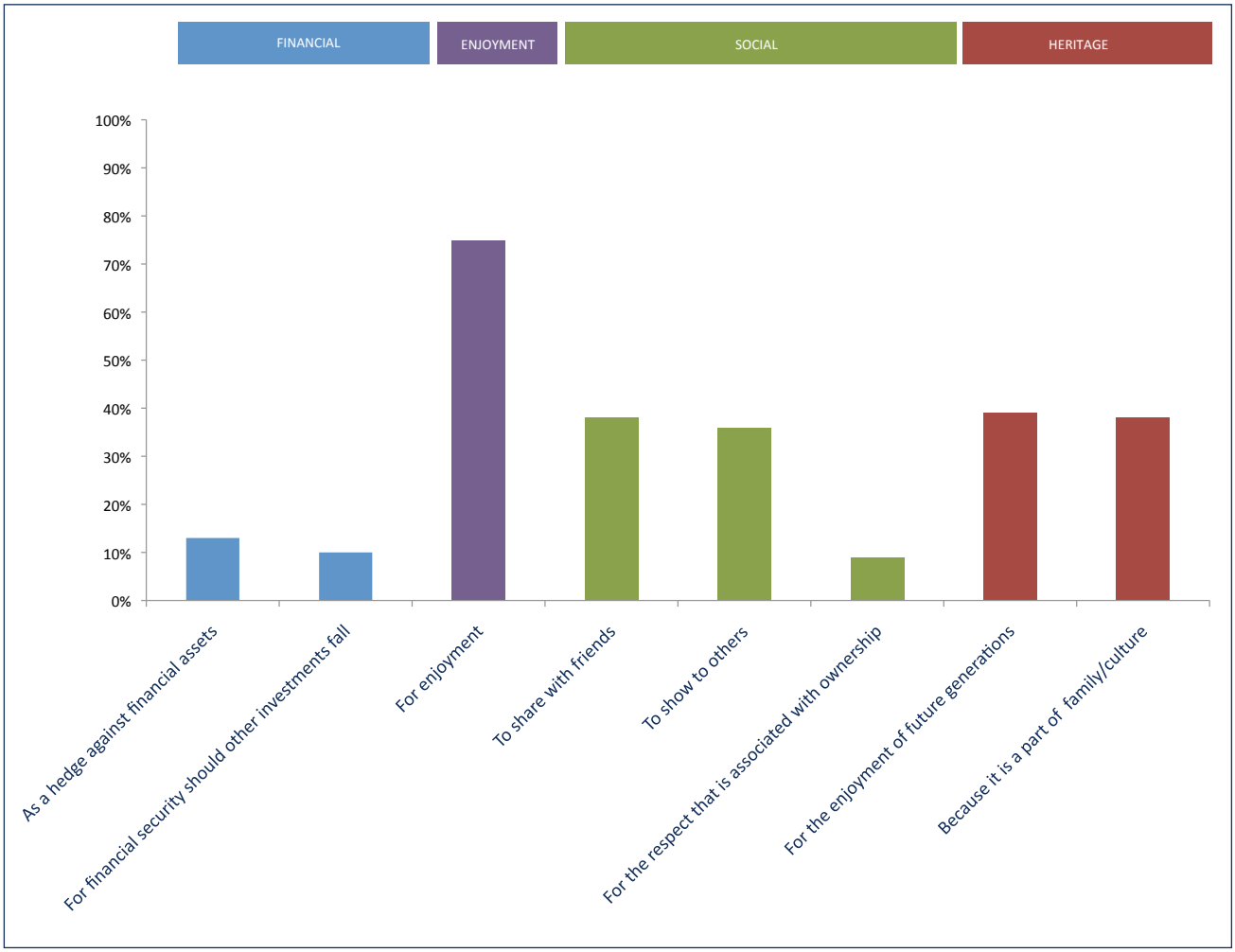
Our behavioural finance team at Barclays has long been interested in understanding the motivations and biases behind investment decision making. We work with clients to help them understand the realities behind their perceptions of investment markets in an effort to improve the financial decisions they make.

As part of a large-scale report[1] into 'treasure investing' we surveyed more than 2,000 high-net worth individuals globally to examine the motivations behind investing in collectables or 'treasure assets', such as fine art.

Despite widespread discussion about the investment opportunities in art, our research found that, for most high-net worth individuals (HNWIs), the primary motivations are still overwhelmingly emotional. Only 10% of respondents globally said they owned fine art paintings purely as an investment. Only 13% said their art ownership is motivated by the belief that such assets will provide financial security if conventional investments fail.

> *"Despite widespread discussion about the investment opportunities in art, the primary motivations are still overwhelmingly emotional"*

Instead, the dominant reason across all types of treasure assets was simply *enjoyment*. 75% of fine art paintings were owned for that very reason. Beyond enjoyment, many respondents own art because of its *heritage value*: 42% of art was owned in part because of a desire to protect it and pass it down for the enjoyment of future generations; and 38% because owners feel it to be a part of their family or culture. A further motivation for buying such assets is social: 36% of our respondents own art for the purposes of showing it off to other people; and 38% because the owners gain pleasure from sharing it with friends. A related,



Source: Barclays' Wealth Insights Report, Vol 15, 'Profit or Pleasure? Exploring the Motivation Behind Treasure Trends'

Figure 1. Motivations for owning fine art (pictures and paintings)

but less selfless, motivation was that 9% thought they gained respect from others for owning art.

These are all excellent reasons for purchasing art. From your purchase you get a stream of emotional benefits. Beauty, meaning, and cultural importance are relatively independent of the value you could obtain from selling the work for profit. Indeed, due to the behavioural *endowment effect* there is an innate tendency for us to ascribe more, rather than less, value over time to things we own, making the emotional returns on a piece of art higher, even if the market value drops. 44% of our art owners in our survey said that they consider their art to be priceless: there is *no* increase in value that would lead them to sell it. This indicates that - despite what we read about art investing - achieving financial returns from art is a long way from the thoughts of many collectors.

Even in cases where the art is not considered priceless, a further 16% of respondents say that they would require a price increase of greater than 50% to be impelled to sell it after the first year of ownership, and 21% would require the price to double!

These results reveal that pure investment motivations are still far from being a primary force behind the art market - something that many who are genuinely interested in art may find reassuring. However, this doesn't mean that the motivation to buy art for profit has not increased in recent years.

"Pure investment motivations are still far from being a primary force behind the art market"

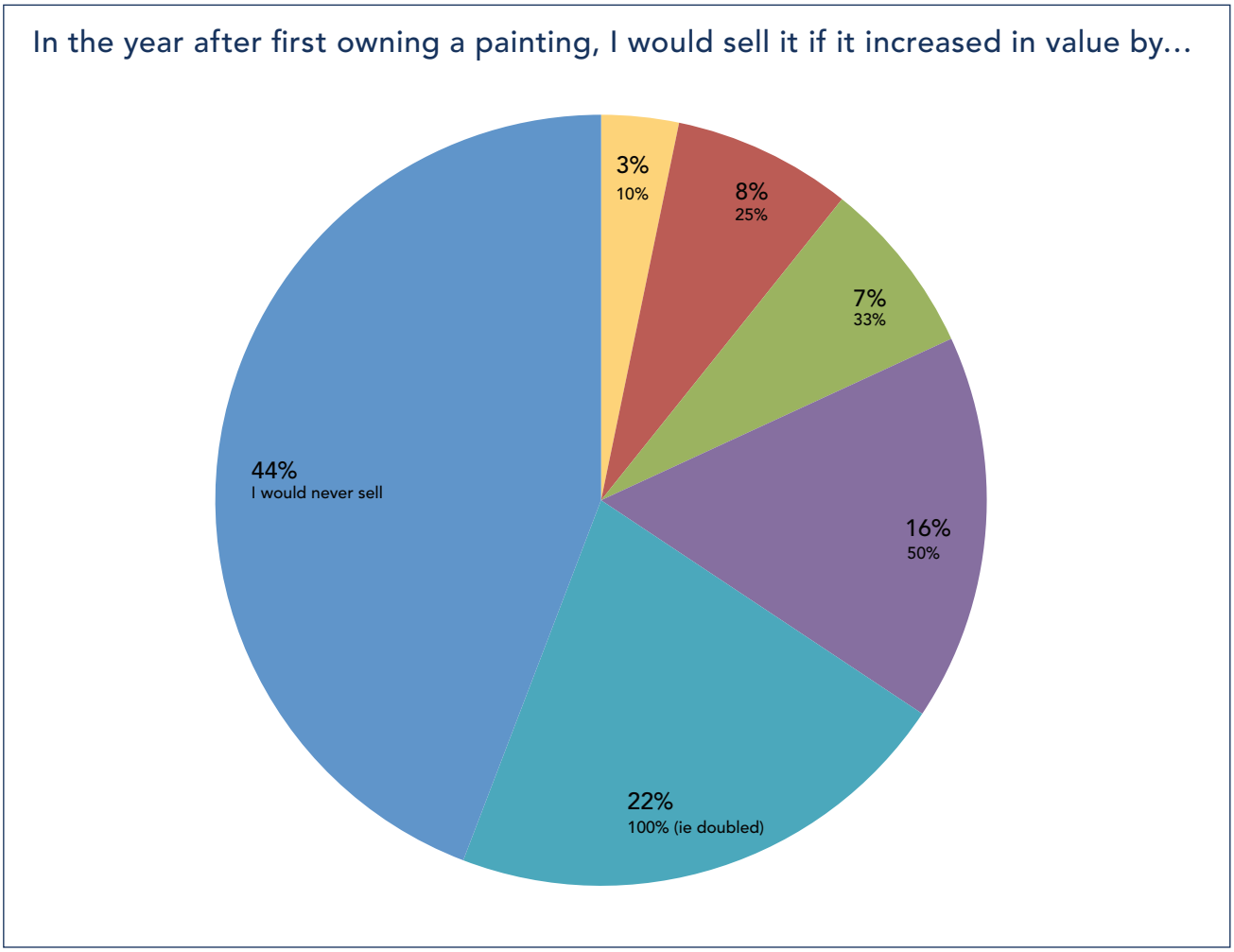


Figure 2. In the year after first owning a painting, I would sell it if it increased in value by...

This may be less due to the increased investment case for art, and more to the reduced appeal of traditional financial investments after the recent credit crisis as investors fled what were perceived to be complex, risky, opaque, and intangible financial instruments; flocking instead to the perceived safety of art and other collectibles as a more tangible, transparent and familiar means of storing wealth. This *familiarity bias* shows up, for example, in investors moving closer to their home markets, and into simpler instruments.

Collectibles have been beneficiaries of this move - relative to an abstract and complex financial instrument, a physical work of art is tangible and real - you can hang it on your wall after all. But this is quite different from understanding the mechanics of its investment value and risk, which are, in fact, considerably more murky and difficult to pin down than that of most standard financial investments. In addition, if the desire for simplicity and familiarity, and to avoid tainted financial markets, is indeed what's driving many purchases of art, then art investors would be committing the cardinal sin of investing: buying what many others are seeking because of short-term emotional reasons unrelated to long-term risk/return expectations, and avoiding assets which are relatively cheap because everyone else is avoiding them. In other words, buying high, and selling low.

The very fact that a piece of art may be emotionally appealing and tangible could blind investors to many of the underlying risks to the future value of the work. Art is a non-productive asset: it produces no interest income, no dividends, and no rent. Positive returns are driven solely by the willingness of someone else to pay more for it than you did - this effectively makes it a play on fashion.

And to earn a positive return, the price must increase sufficiently to overcome the substantial transaction costs (up to 25% of the hammer price), the costs of carry (insurance, storage, maintenance, transportation, security) which can amount to between 1% and 5% of the value of a collection annually, and tax costs where appropriate[2]. And then there are the added risks of fraud, market manipulation, information asymmetry, and very low liquidity.

> *" Art markets are unregulated, opaque, with high transaction costs, bid/ask spreads and barriers to entry"*

Auctions, also, are an emotional and financial minefield, culminating in the so-called *winner's curse*: at the point of sale, the winner of competitive bidding in an auction is the individual who places the highest value on the item. No-one else who can afford it thinks it is worth that much, or they'd have counter bid. Worse than this, the whole theatre of the auction is aimed at pushing bidders to the limits of their valuation. The winners curse poses a major hurdle to reliably realising a profit from art investing.

Yes, there are many examples of artworks that have gone up in value so substantially that the owners were handsomely rewarded for the risks, but even the most spectacular cases turn out to be considerably more pedestrian when we calculate the compounded annual return over time, after fees and expenses. We should be very careful about forming judgements on any asset class by looking only at the most extreme, publicised, and cherry-picked examples, but hugely more so when the assets are as emotionally laden as art is.

Nonetheless these highly publicised examples tap into our psychological make-up. We often evaluate options by the ease with which we can bring specific examples to mind, known as the *availability bias*. The media attention given to investment success stories in the art world leads naturally to biased perceptions of how easy it is to make money from buying art.

This doesn't mean that investors can't make money from art. It does, however, mean the average investor probably shouldn't try. There may be some financial benefits from diversification, but art markets are unregulated, opaque, with high transaction costs, bid/ask spreads and barriers to entry. Unlike equity and bond markets, without being a specialist insider it is simply not possible to buy a random, diversified portfolio of assets that has positive expected return. And, unlike equities and bonds, it is not possible to construct a market index that is independent of expertise and skill.

Even in the best-constructed art indices, what goes into the index are artworks that have been hand selected by industry insiders who are heavily incentivised to only accept those works that are expected to sell well. These insiders can then strongly influence the valuation at the only moment that matters, the auction, through control of the environment, marketing, price guarantees, reserves, etc. It's as if the FTSE100 was constructed by the stock exchange each month selecting the stocks it thought had the best chance of going up, and then recording the price at a specific moment of their choosing after extensive marketing and media attention on the positive aspects of those few stocks, providing guarantees to those prepared to sell on that day, and funding for those prepared to buy. Any index constructed on this basis would dramatically overvalue the state of the market as a whole.

Art indices are not investible and, without serious expertise and insider knowledge, the expected returns from a randomly chosen selection of art are likely to be negative.

Of course, it is precisely in those less-transparent and less-efficient markets that the returns to genuine skill and expertise are highest - insiders reap the benefits of their knowledge and the high transaction costs and spread. The lesson from all of this is not that art investors can't make money but, unless you seriously know what you're doing - or can pay someone who does - the odds are strongly stacked against you.

For those investors who are sufficiently willing to seek returns through skill, art funds may well be a good

option for a small portion of their total portfolio. Buyers of art funds need to be acutely aware that they are not buying the art market, they are buying the insider expertise of the fund manager - these are two very different investment propositions. Skill can certainly lead to good returns, particularly in less-regulated and less-efficient markets, but betting on skill is very risky. It is difficult for non-experts to accurately evaluate insider skill, and it doesn't always pay off - it is worth bearing in mind that most of the art funds ever started have failed.

In the end, art offers a great return but it often isn't financial. Enjoyment, heritage, and cultural value are what art is for and, on these, it delivers very well. Your collection may indeed bring financial rewards if you're lucky, or skilled, but the emotional return is far more certain.

But even if pleasure is your fundamental aim, it doesn't mean that you should ignore investment considerations. Enjoyment, like anything, can be attained expensively, or efficiently. Buying art for purely emotional reasons, without thinking through the financial aspects, may mean paying too much for those emotional returns. Approaching art purchases with a combination of both head and heart can help you to attain the maximum emotional returns for your budget. ■

[1] Barclays' Wealth Insights Report, Volume 15, 'Profit or Pleasure? Exploring the Motivation Behind Treasure Trends', 2012

[1] http://online.wsj.com/article/SB10001424052748703959704575453162597091330.html