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Thinking of investing in art? Read this first

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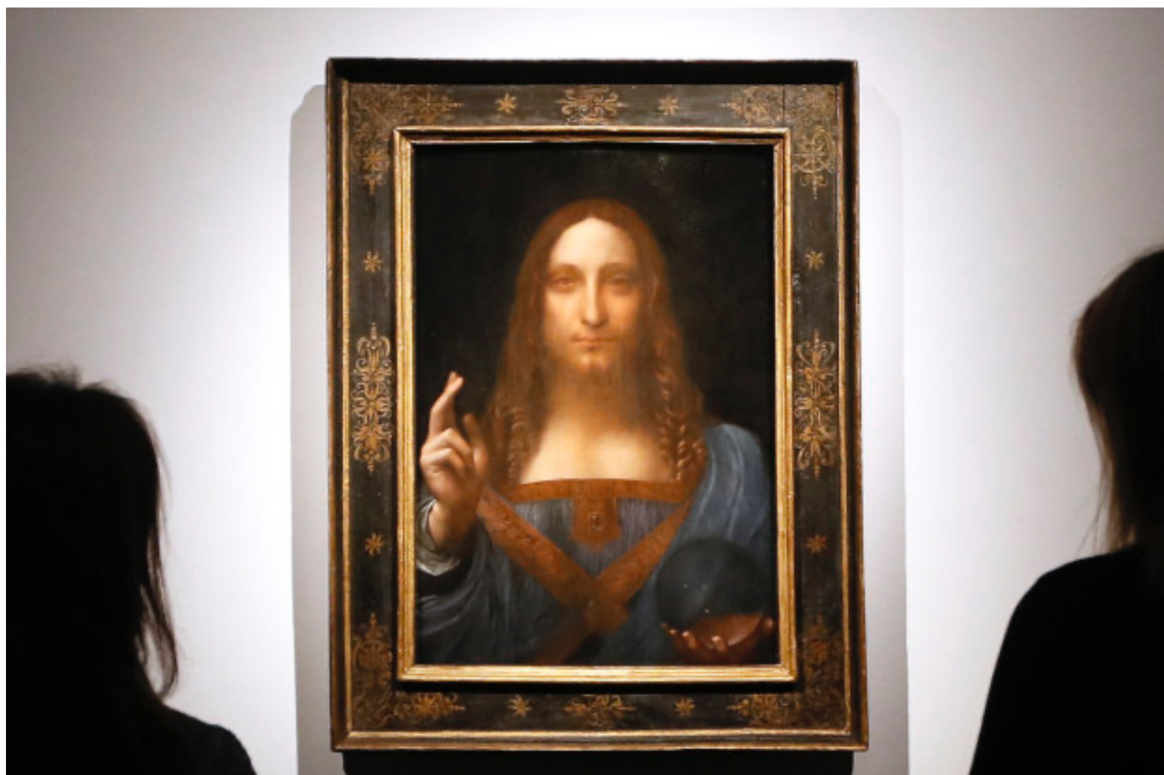
In November 2017, in a packed auction room in New York, da Vinci's *Salvator Mundi* sold for $US450 million. That spectacular transaction says many things about our age. One of them, surely, is that at that moment the idea of art as an asset went mainstream. You don't pay $US450 million ($627 million) for wall decoration.

Over the last decade or so, supporters of the art market have been arguing that art should be viewed as an asset. Are they right? An asset is simply a "store of value", something that can be purchased today and will hold its value over time. Art undoubtedly satisfies that definition.



Leonardo da Vinci's Salvator Mundi captured the world's attention when it sold for $US450 million in 2017.

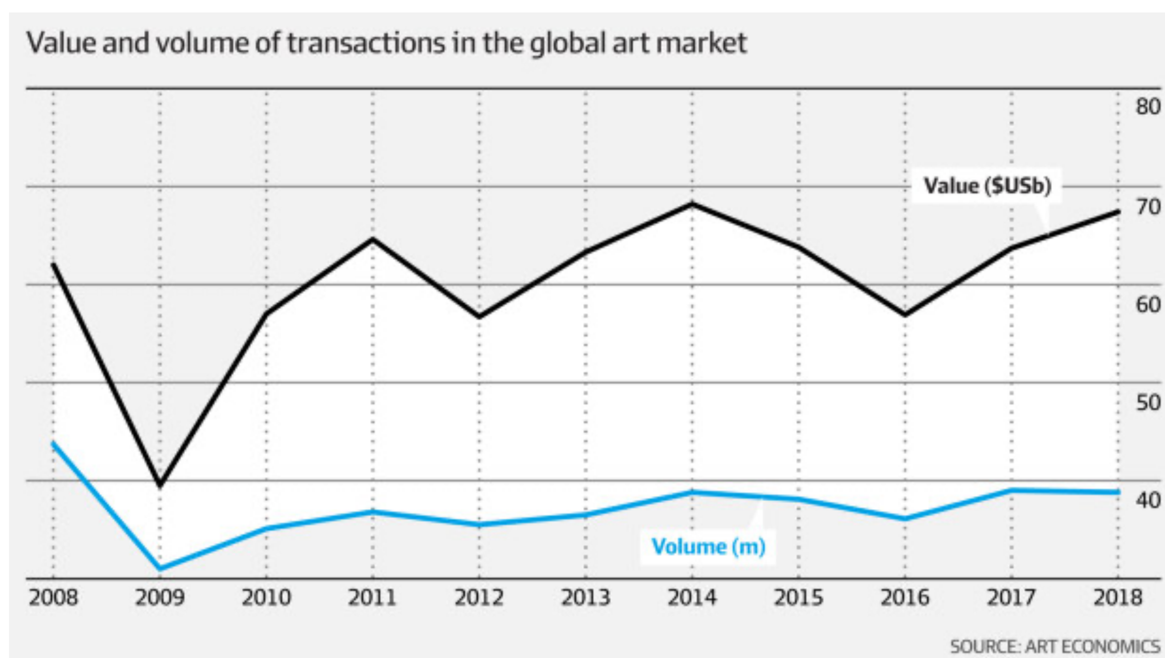
Art's credentials as an asset have strengthened greatly with the growth of the market. Global art sales were $US10 billion in 1990. Last year, according to the 2019 Art Basel UBS Art Market report, released a few weeks ago, the market topped $US67 billion.

Galleries account for just over half the market - $US37 billion in sales with auctions comprising $US29 billion. The US is easily the biggest market, with Britain second and China a close third. In something of a lengthy digression, the report investigates gender discrimination in art. It reveals that artworks by women sell, on average, for 38 per cent less than works by men.

Rise and fall in growth

However, growth in this multi-billion dollar market has been patchy over the past decade and the volume of transactions has also chopped and changed. Overall value was up year on year in 2018, but over the past decade, the net gain over 10 years is 8.7 per cent - barely keeping up with inflation. And the volume of transactions was lower in 2018 than it was in 2008. Both the value and volume of transactions dipped substantially in 2009 with the global financial crisis cruelling the art market as economic activity slowed.

Overall, however, it's difficult to determine the role played by external factors. While the relationship of standard financial assets like stocks and bonds to interest rates, economic activity is closely tracked, the influence of such factors on the value of art is little understood. Media coverage over the years suggests those few artworks valued at over $US1 million – which account for 60 per cent of auction turnover by value – may have appreciated more strongly than artworks at the lower end of the market but detail is scant.



Let’s not blame the Art Basel report – it is actually a high quality effort. The problem is that the art market diverges from the ideal efficient market blueprint in just about every possible way. There is no “standard” art work, transactions are difficult and costly, and market information is chronically poor. It’s about as opaque a market as you can find.

Looking at this market through the eyes of an investor, what can art offer? Like, say, real estate, it boasts strong capital gains over the longer term. Price escalation has been a major contributor to the 600 per cent growth in turnover since 1990. Advocates say that returns in this market are uncorrelated with the returns from other asset classes, making it attractive for inclusion in a diversified portfolio.

The allure of art

Art is both durable and highly mobile. Various airports in Europe and elsewhere host tax free storage zones where valuable artworks can be held. If a painting quietly changes hands and moves from one storage suite to another, who is to know? Individuals unhappy with their tax bills or nervous about their spouse’s divorce lawyers have been known to exploit these characteristics to great effect. And, of course, art emphatically offers aesthetic returns – it looks great on the living room wall while you await the capital gains.

But art has an Achilles heel – it is difficult to buy and sell. Identifying reputable current artists, knowing what a “fair” price is and who might pay it, understanding a work’s provenance, the risk of forgery, the list goes on and on.

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Transaction problems are often referred to as “information asymmetries” – a few people know a great deal and lots of people don’t know very much. Little wonder that the market relies so heavily on intermediaries like galleries and auction houses. Intermediary services come at a cost, one that broadly reflects their contribution to “market making”. As you would expect, the higher the risk, the higher the fees.

These intermediaries warrant a closer look. The business of most local galleries is selling new work by their roster of artists – this is the so-called “primary market”. The primary market bears the highest risks in the art market because it deals with artists who may not have a strong market for their work.

To compensate for this risk, these galleries charge high margins – commonly 50 per cent and sometimes more. In some industries a 50 per cent margin is the stuff of dreams – and indeed galleries are sometimes criticised for taking money out of the hands of needy artists.

The struggle for recognition

For the most part, this criticism is misplaced. Not only do galleries provide nice premises for displaying art and develop a network of potential buyers but they also provide artists (especially emerging artists) with lots of ancillary support. This is costly and risky – not every artist finds a market for their work.

One famous example is the London-based dealer Paul Durand-Ruel, who supported the Impressionists. He eventually became wealthy from selling their art, but only after 20 years of financial peril supporting those artists in the face of almost non-existent demand. Little wonder that many small galleries struggle to break even.

Another important group of intermediaries is auction houses that handle nationally known artists. They charge a "buyer's premium" of around 22 per cent (but negotiable) on works they sell. Dealing in known artists is less risky than creating a market so margins in this secondary market are lower than gallery fees.

Most prominent of all art intermediaries are the global auction houses that sell globally recognised artists. Christie's and Sotheby's are the biggest and between them account for 40 per cent of the entire global auction market. For a work valued at, say, $US1 million, the buyer's premium would be around 14 per cent. This is less than nationally focused auction houses but still yields a hefty commission for works valued in the millions.
Essential though they are, these service providers eat into art investment returns. It's not encouraging to buy some carefully chosen art, only to see hard-won gains being swallowed up by transaction fees. Having said that, these intermediaries collectively offer a comprehensive menu of risk-reward combinations to art buyers.

Unknown, higher risk artists are typically priced lower, increasing the prospect of strong returns. Well-known artists sell for much higher prices, meaning lower but less risky expected returns. The market knows how to price risk.

Surprise on the upside

The Art Basel report estimates that about 40 million items sold at auction in 2018. That makes the market sound more liquid than it really is. In 2008- 2009 market sales declined by a huge 40 per cent as supply contracted in response to the global financial crisis. (It recovered thereafter.) A lack of liquidity can sometimes impact a specific area. European Old Masters seems to be a current example. Turnover in this market segment has been declining steadily and in 2018 reached its lowest level in 10 years.

Asset markets like art also sometimes surprise on the upside. The economist Robert Shiller won a Nobel Prize for his work on asset markets and, in particular, the idea of "irrational exuberance". He argues that price spikes can be expected in markets like art when sensible investors are confronted with poor information and shifting psychology among other investors.

One way to express Schiller’s argument is that asset markets like art are
prone to making price “mistakes” from time to time. Prices at auction are, of course, correct at the moment the gavel falls. If those price levels hold up, fine. But if prices are not maintained in later trading, perhaps a mistake has occurred. The 2017 sale of *Salvator Mundi* was a mistake in the sense that it was a price spike.

Mistakes can, of course, also appear in the form of bargains. The historically low prices for the work of women artists have perhaps been a mistake and one that could be slowly correcting - the *New York Time*s has recently noted the frequency with which female artists are now setting price records. The timing of corrections though is, alas, unknowable.

The hard-nosed conclusion is that art is an asset, but an inefficient asset. It doesn’t offer what we value in financial assets – a regular income stream, a known risk profile or market liquidity. Investors, if rational, should favour financial assets. It's just that financial assets don’t look so pretty on your walls.

Andrew Bailey is the editor of the weekly art newsletter The Easel.