Chilton Trust

Art as the Accidental Asset

Evaluating the complexities of viewing art as an investment.

What role can art play as an asset?

When the characteristics of art and its market are considered, the answer to the question historically has been *an accidental one*.

The accident being that most art collections are formed by private collectors, and most of these collections are formed out of passion and connoisseurship, rather than a conscious desire to build a "portfolio." That said, many art collectors—or often their heirs or the executors of their estates—realize one day that the previous generation's passion for collecting art has blossomed into a taxable asset, leverageable collateral or marketable commodity.

For decades, art market participants and non-participants alike have aspired to "recreate the accident" by buying art not as a passion asset but as a financial one. While art objects may constitute an asset for inclusion in one's overall net worth for planning purposes, classifying art as an investment is fraught with difficulties. Art as an object is unquestionably unique among other assets and the skepticism surrounding art as an asset class has less to do with the objects themselves than with the market in which they trade.

The key drivers complicating consideration of art as an investable asset are:

- Valuation is subjective, inefficient and not entirely based on "fundamentals"
- The market lacks necessary transparency to establish trading fidelity
- Supply and demand are driven by humanistic events and not by traditional market forces

A particularly poignant example of the contrivances of the art market is the recent sale of the Macklowe Collection, a group of artworks put into receivership as a result of divorce proceedings. From the beginning of this collection's path to sale, the art market's peculiarities were put on display.

Pricing Inefficiency

The very basis of "fair market value" is unfettered access to all available information, and yet the valuation of art rarely benefits from such transparency. During the divorce proceedings, Mr. and Mrs. Macklowe each engaged their own appraisers, with Mr. Macklowe selecting Winston Fine Art and Mrs. Macklowe choosing Gurr Johns.

Though each firm was appraising the very same works of art, the difference in the respective firms' aggregate valuations was over $150M (a range of $626M – $789M). Particularly of note: one work, Le Nez by Alberto Giacometti, was appraised at $35M by Gurr Johns based on comparables sold at auction. Winston, on the other hand, came in at $65M, citing recent private sales of similar works by the artist[1]—sales that, presumably, weren't known to Gurr Johns or which they chose not to factor into their valuation. Ultimately, the work sold for an all-in price of over $78M at Sotheby's in November 2021.

Conflicts

In addition to the opacity of valuations, sales within the art market are also imbued with conflicts. Albeit disclosed by law, many high-end works of art are sold subject to special circumstances in which interested parties may be bidding on works at auction. As was the case in the Macklowe Collection, the entire collection was subject to a guarantee, which means that no matter the results at auction, the sellers would receive an agreed-upon payment from the auction house or its financial partners.[2] Additionally, certain works—37 of the 65 works for sale—carried "irrevocable bids" in which an unnamed bidder agreed to buy the work at a pre-determined price. Moreover, if this bidder was not the winner, he or she would be "compensated based on the final hammer price," and if this bidder won, he or she might have "receive[d] a fixed fee…netted against the irrevocable bidder's obligation to pay."[3] Effectively, the irrevocable bidder is incentivized to bid-up the work at auction in order to reap a fee while also knowing that, if their own bid is successful, his or her price will be subsequently discounted by receiving the "fixed fee" against their winning bid.

The Four "D's"

Death, debt, divorce…and discretion.

The last "D" notwithstanding, most collections and many single works come to auction as the result of an unforeseen life event, as was the case with the Macklowe divorce. Such sales events are not a function of rebalancing, re-allocating, or other strategic portfolio decisions, and yet these transactions can have an outsized effect on the markets for artists in the collection.

In fact, the Macklowe collection's total across both sales was over $922M, making it the most valuable single owner collection ever sold; within the sale, numerous price records were set for individual artists, establishing new high-water marks for works by these artists and likely driving valuations of works by the artists for years to come…all because a marriage ended.

The most curious aspect of art as an asset is its transformative property: unlike any other asset, works of art are traditionally acquired out of hobby and passion without regard for their investment potential. Over time, however, these same objects of beauty can transform into a good investment, and their disposition can be a taxable event.

Most true connoisseurs engage in collecting art with no expectations that the objects will appreciate in value; that said, once owned, art becomes an asset that must be managed like any other. Those who aim to "repeat the accident" and purchase art for its investment potential are strongly cautioned to observe the complicated aspects of valuing art, predicting its future value, trading within an opaque market and owning valuable objects with substantial carrying costs.

Examination of the sale discrepancies in the Macklowe Collection highlights the reason art should not be pursued as an investment. However, prospective collectors should plan and consider the following pertinent questions if an accident asset is to emerge:

What role might art play in my portfolio?

To access equity within art holdings, artworks must either be sold or leveraged, with the understanding that art that is held "long" does not produce any cash-flow. With these characteristics of art in mind, art holdings should be viewed similarly to private equity, venture capital or "angel" investments since they, too, typically require long holding terms and often have "lock-up" periods of shorter terms in which the investment cannot be exited. Quick "flips" of major artworks are usually not favorably viewed by art market participants—this is the "lock-up"—and most works of art that have appreciated significantly have been held by the same owner for either side of 10 years.

Beyond market opacity, valuation subjectivity and illiquidity, what are additional risks and considerations associated with buying, selling, and owning art?

Art is expensive to own and carrying costs must be considered either for collectors with no intention to sell or for owners seeking an investment return. Valuable artworks must be insured at a level that exceeds a common homeowner policy's "contents rider." Should artwork need to move locations, professional art handlers should be employed to ensure proper crating and transportation.

For the uninitiated, art transaction costs can be eye-popping. Most auction houses charge a "buyer's premium" to the successful bidder of works sold at auction. Generally the premium is about 25% on the first $1 million, and then 20%+/- on the next $5 million and another 15%+/- on any amount above. (Of course, these numbers can vary from auction house to auction house and are subject to change at each house's discretion).

For example, if a work of art sells at auction in New York City for a "hammer price" of $10 million, the successful bidder will actually pay $12,843,375—that includes the Buyer's Premium of $1,810,000 and, if the work is delivered to a New York City address, another $1,033,375 of sales tax. A grand total of nearly $3 million in charges over the "hammer price" must be paid by the purchaser.

While buying and selling privately is typically a simpler "all-in" price structure, when buying through a dealer, prospective purchasers should be aware of any post-sale terms the dealer may impose, such as a right of first refusal that would require any resale of the work first be presented to the dealer before any other offers are entertained.

While sellers of major works and collections usually can negotiate favorable vendor's commissions and terms, those can still range from a low 1% up to 10% or more that will be subtracted from the net proceeds. More importantly, artwork is subject to a long-term capital gains tax of 28%—quite a bit more than the long-term rate of 20% collected on financial assets.

Can I "recreate the accident" in a deliberate manner to achieve specific investment goals?

Accurate valuation data and analysis is tantamount to achieving investment objectives, and if a prospective purchaser of art intends to hold it for investment purposes, the same would be true regarding pricing of the work. Observations of the Macklowe sale vividly illustrate that valuing high-end art requires not only specific expertise but also insider knowledge. Most valuations of artwork begin with a quantitative screen of publicly available and verifiable auction records. Appraisers with deep knowledge of both public auctions and insider knowledge of private transactions would then apply a qualitative screen, select the most relevant comparables and assign a value. However, for a work of art in which "quality" is the driver of value, judging what is quality today and what may be judged as quality in the future is largely without quantifiable metrics: scholarship, historical context and collecting tastes all can undergo various degrees of change over time.

Old Master paintings and sculptures have the longest history of "price discovery" in the fine art market, followed by Impressionist art, Modern art and then Contemporary art – the latter generally meaning Post-War art and the decades following. More recently, "contemporary" art has begun to include works by living artists whose secondary markets are nascent at best. In this segment of the market, prospective art investors should be cautious of errant market trends. For example, an artist's works may rise in value because a well-known collector makes public mention of owning works by the artist; or occasionally a dealer may promote works by an artist with whom he or she is involved personally. Each of these situations and others like them can artificially, and often temporarily, inflate

prices of works by an artist without proper consideration of historical importance or artistic qualities.

In the equity markets, price discovery is a necessary element of determining value of broadly traded securities, and in addition to fundamental, bottoms-up analysis, a depth and breadth of pricing history is key to establishing accurate valuations. In the art market, such reliable fundamental and historical pricing data is not uniformly available or accessible, and therefore buyers of art for reasons other than passion and aesthetic appreciation should be conscious of an artists' tenure in the market and the historical context of his/ her works.

Conclusion

The most curious aspects of art as an asset is its transformative property: unlike any other asset class, works of art are traditionally acquired out of hobby and passion without regard for their investment potential. Over time, however, these same objects of beauty can transform into a good investment, and their disposition can be a taxable event.

Regardless of intent when purchased, once owned, art becomes an asset that must be managed like any other. If an investor aims to "repeat the accident" and purchase art solely for its growth potential, the many unique and complicating aspects of art, its market and the conditions of ownership should be carefully considered.

Notes

1. Kinsella, Eileen. "Judge Orders Collectors Harry and Linda Macklowe to Sell Their $700m Million Art Trove and Split the Proceeds." Artnet, December 14, 2018. https://news.artnet.com/art-world/new-york-judge-orders-harry-linda-macklowe-divide-sell-700m-art-collection-1420273
2. Brady, Anna. "Sotheby's wins 'dogfight' to sell $600m art collection of Harry and Linda Macklowe." *The Art Newspaper*, September 9, 2021. https://www.theartnewspaper.com/2021/09/09/sothebys-wins-dogfight-to-sell-dollar600m-art-collection-of-harry-and-linda-macklowe
3. www.sothebys.com. "Symbol Definitions." https://www.sothebys.com/en/digital-catalogues/the-macklowe-collection

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Hypothetical cash flow analysis: Stocks are proxied by the S&P 500 Index
The S&P 500 Index is a stock market index tracking the performance of approximately 500 of the largest companies listed on stock exchanges in the United States.
Bonds are proxied by the Bloomberg Barclays U.S. Aggregate Bond Index
The Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate pass-throughs), ABS, and CMBS (agency and non-agency).
The Hypothetical Cash Flow Analysis is based on Monte Carlo analysis.
Monte Carlo simulation is a stochastic modeling technique which leverages Chilton Trust's proprietary Capital Market Assumptions (CMAs) as inputs and, assuming the returns are approximately normally distributed, performs thousands of simulated iterations which result in wide variety of potential portfolio performance outcomes.
Capital Market Assumptions (CMAs) consist of historical asset class returns, standard deviations, correlations, and yields but also take into account Chilton's forward-looking views on the markets. Actual investment results experienced may be higher or lower than forecast due to market uncertainty.
Correlation is a statistical measure of the strength of the relationship between the relative movements of two variables. More specifically in our case, the Pearson correlation coefficient measures the linear relationship between 2 sets of asset class returns. It is the ratio between the covariance of the asset class returns and the product of their standard deviations.
Standard deviation is a measure of volatility expressed as a standardized deviation from the mean. Essentially it is a measure of the dispersion or variation of a set of values. Assuming the set of values is normally distributed, 95% of the values will fall approximately within plus or minus 2 standard deviations from the mean.

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