Art of the Deal

Contemporary Art in a Global Financial Market

Noah Horowitz

PRINCETON UNIVERSITY PRESS • PRINCETON AND OXFORD

COPYRIGHT © 2011 BY PRINCETON UNIVERSITY PRESS

Published by Princeton University Press,
41 William Street, Princeton, New Jersey 08540
In the United Kingdom:
Princeton University Press,
6 Oxford Street, Woodstock, Oxfordshire OX20 1TW

press.princeton.edu

All Rights Reserved

Library of Congress Cataloging-in-Publication Data
Horowitz, Noah, 1979–
Art of the deal : contemporary art in a global financial market / Noah Horowitz.
p. cm.
Includes bibliographical references and index.
ISBN 978-0-691-14832-8 (hardcover : alk. paper) 1. Art—Marketing—History—20th century. 2. Art—Marketing—History—21st century. 3. Art—Economic aspects—History—20th century. 4. Art—Economic aspects—History—21st century. 5. Art as an investment. I. Title. II. Title: Contemporary art in a global financial market.
N8600.H67 2011
382'.457—dc22 2010021904

British Library Cataloging-in-Publication Data is available

This book has been composed in Sabon with Trade Gothic Display

Printed on acid-free paper. ∞

Printed in the United States of America

10 9 8 7 6 5 4 3 2

For Louise

Chapter 3

Art Investment Funds

Let us begin by comparing two quotes, the first by art historian Leo Steinberg in 1968, the second by Bruce Taub, chief executive officer and founder of Fernwood Art Investments, in 2004:

> Avant-garde art, lately Americanized, is for the first time associated with big money. And this because its occult aims and uncertain future have been successfully translated into homely terms. For far-out modernism, we can now read "speculative growth stock"; for apparent quality, "market attractiveness"; and for an adverse change of taste, "technical obsolescence." A feat of language to absolve a change of attitude. Art is not, after all, what we thought it was; in the broadest sense it is hard cash. The whole of art, its growing tip included, is assimilated to familiar values. Another decade, and we shall have mutual funds based on securities in the form of pictures held in bank vaults.[1]

> We are the first independent firm to develop a comprehensive suite of art-focused investment research, advice, financial products and services for sophisticated investors and collectors. Our work generates new ways to participate in the art market and, in the process, brings significant new capital to the art economy. In short, Fernwood is employing rigorous portfolio management techniques traditionally applied to equities, bonds and commodities, in combination with academic and art trade expertise, to derive investable art insight.... The difference between art collecting and art investing *is* Fernwood.[2]

Read in succession, these passages have that uncanny feeling of fate being sealed. Writing as the new order of the 1960s contemporary art market

was still taking shape, Steinberg foresees the ultimate instrumentalization of art as *nothing but* a financial asset, and Taub, writing at the dawn of the twenty-first century, confirms his fears. Conceived as a sophisticated art finance business offering both art investment platforms and related market services, Fernwood certainly was no mere mutual fund.

Steinberg's remarks form part of the historian's seminal writings on the shifting terrain of modern art, and they could not provide a better historical framework for our own enquiry into the proliferation of art investing.[3] Taub's comments, on the other hand, spell out Fernwood's grand vision and are representative of the current art fund industry—of just how far into the throws of "big money" art has gone.[4]

Fernwood was founded in 2003 by Taub, formerly of Merrill Lynch, on the conviction that art constitutes a viable alternative financial asset class that can be exploited through strategic trading. To achieve this vision, it set out to raise $150 million to be invested in two primary art funds: a Sector Allocation Fund that was to be diversified across eight genre categories (spanning Old Masters to Emerging Masters); and a higher-risk Opportunity Fund established to capture "more immediate opportunities within the broader art economy for financial returns."[5] Split between offices in New York and Boston, the firm hired twenty industry professionals, from auctioneers and dealers to economists and art critics, to achieve these ends.

Fernwood was not alone. One year earlier, the Fine Art Fund (FAF) had been inaugurated in London by ex-Christie's veterans Philip Hoffman and Lord Gowrie, with an even more ambitious investment target of $350 million. And scores of other art investment funds and syndicates had either just been set up or were on the horizon, such as the China Fund (by Julian Thompson and Jason Tse, both formerly of Sotheby's), ArtVest (by Daniella Luxembourg, former cohead of Phillips de Pury & Luxembourg), and Aurora Fine Art Investments (by Russian billionaire Viktor Vekselberg). With its finger hot on the pulse, Dutch bank ABN-AMRO in 2004 announced its intention to inaugurate a fund of its own as well as an art investment "fund of funds," which would make investments across this burgeoning landscape.[6] (Appendix C provides an overview of these funds.)

Not even a decade on, this field has already taken a different shape. ABN-AMRO's multiple ventures never progressed beyond the planning stage, Fernwood was dissolved in 2006, and many other upstarts that once lit the landscape have since faded from view.[7] Even FAF, the largest fund currently in existence with $89 million under management spread across four different investment vehicles, has raised less than a third of its original target and is close-lipped about its overall performance.[8] The industry, like any business sector in its early phase of development, is a work in progress, and it is critical for us in the context of this book to

cautiously adjudge its evolution: it could go on to thrive in the years to come, but the outcome of its particular marriage of art and finance remains difficult to foretell.

What is certain is that while the art fund industry is apt to transform for the foreseeable future, the rise of art investing—as an idea and business practice—offers one of the clearest illustrations of how the market has changed since Steinberg's day. For it is not only emblematic of the enterprising new ways in which contemporary art is sold and experienced, as examined in the preceding chapters, nor of how the art economy as a whole has embraced globalization; it is modern global finance embodied.

Few topics in the art market have been as energetically discussed yet as poorly understood as investing. This is largely due to its controversial nature. For many artists, as well as much of the art world, the practice is seen to bankrupt art of all meaning and metaphysical value; it is a further and severe encroachment of capitalism into the cultural sector. Dealers tend to share this opinion and also see art funds as a competitive threat. The funds themselves are under no illusions that they are trying to profit through art but see their activity as opening the benefits of participation in the art market to wider numbers of people than ever before (who can now buy and sell shares of a fund) as well as bringing a much-needed boost of liquidity and transparency to a market otherwise synonymous with its opacity and lack of regulation. These latter objectives, however, tend to get muddled between stark fundamental opposition to art investing and the art world's inability, or palpable disinterest, to understand funds' financial jargon. Resistance is also apparent in the broader financial community, which struggles to understand the art market and to accept art as a viable asset class. From both sides, art funds tend to be seen as "outsiders," distanced by a linguistic and cultural gap.

Many commentators have been quick to designate the growth of art funds as evidence of a new dynamic in the trade, though few have paused sufficiently to address how these businesses are run and what their effects actually are on the structure of the art market; most discussion is highly speculative in character. This is evident both in casual banter and also in some more serious literature, such as Louisa Buck and Judith Greer's *Owning Art* (2006), which presents dazzling contemporary art sales figures during the post-2000 boom period to conclude that "these huge profits have meant that art is increasingly viewed as an alternative asset class."[9] Such viewpoints are not incorrect—the promise of vast riches may certainly encourage some to invest in art—but they miss the crux of what is fundamentally unique about our current moment: the extent to which the vogue in art investing has been driven by the coming together of the worlds of art and finance. Art investing, as we will see, is not novel, and

past market booms have borne their share of speculators-cum-investors, but never before has there been such an emphatic spillover from finance to art about how to achieve this.

I should clarify that there is a fine line between being attracted to art's investment prospects—the halcyon vision, so prevalent of late, that prices will continuously ascend—and buying art solely for this purpose. Even now, as classic forms of connoisseurship are on the wane, the promise of making money tends only to be one of many factors motivating collectors' purchases. Similarly, the prestige buying that swelled contemporary art prices in the new millennium as new collectors, from hedge fund titans to Russian oligarchs to Middle Eastern royalty, turned to the field to mark their distinction (social, cultural, political) must be kept separate from investment in art for financial returns alone. Prestige buying is extraordinarily important to contemporary art's globalization and its constitution as a status symbol par excellence, but it will not be addressed in much detail here. Several writers have published widely on the topic and, as I shall attempt to justify below, it is arguably not as singular to our current moment as the art investment turn.[10]

Our final case study looks at the phenomenon of art investing through the consolidation of the art fund industry, the purest manifestation of art's conscription to the world of "big money" and "familiar values" projected by Steinberg. It describes what these businesses do, the context out of which they have arisen, and the opportunities and challenges they face. While our two preceding chapters focused on some of the key recent developments in the coming together of art making and economics, the present is a more explicitly financial undertaking; "art" itself can often seem missing from the equation, being reduced by investors to a purely instrumental function. Furthermore, whereas my analyses of video and experiential art mainly looked at the primary market, the secondary market wins the bulk of attention here. Art funds tend to operate in the resale sector, where values are more established and works can be traded more seamlessly and discreetly. With few exceptions, my earlier emphasis on contemporary art takes a backseat to these funds' search for investment opportunities across the broader art economy.

I begin with an introduction to the logic of art investing and to the structure and operation of art funds. Next, I return to the origins of art investing in the early twentieth century and examine how the field has changed from then to now. I look at some historical precedents to the current practice as well as the body of economic literature that endorses it and how growing sophistication within the global financial marketplace has catalyzed interest in its benefits. I then open onto a comparative analysis with the hedge fund and private equity industry to set art funds in context. We will see that although art may possess a theoretical investment utility, overcoming conflicts of interest, managing investment risks, and achieving real returns are difficult. These issues are overlaid with more general reflections on the impact that the changes in the art market observed in the earlier case studies may have on art investing and whether the rise of these speculative practices might, ironically, threaten the prestige values that make art so coveted in the first instance.

A definitive assessment of this terrain cannot occur until one is able to track the performance history of today's current generation of art funds. This may not be possible for another decade, perhaps longer. Nevertheless, it is now an opportune moment to begin coming to terms with their implications and, in the context of this book, to develop a more sophisticated understanding of their broader relevance within the present-day art economy.

Overview

The premise of art investing is fairly intuitive: to buy cheap and resell at a premium while minimizing the onerous transaction, shipping, storage, and insurance costs that make art an expensive asset to hold. Two widely held assumptions undergird this basic objective: first, that art as an asset class is weakly or noncorrelated to the international equities markets (e.g., that art prices essentially move independently of other more conventional assets like stocks and bonds);[11] and second, that the art market is highly inefficient, riddled by opaque prices, low levels of liquidity, and large informational asymmetries. These points are germane for if art funds' buy low–sell high principle is self-evident enough, what distinguishes them from other market speculators is their ability to strategically unlock art's supposed noncorrelation benefits and to profit from the market's inefficiencies. Their premise, then, is to concentrate a critical mass of art and financial expertise under a single umbrella to make this a realizable goal.

We can appreciate the tenets of this strategy through comparison with the recent economic climate. Following a period of extended growth, the global financial market nosedived beginning in autumn 2007 owing to the residual fallout from the housing crisis and the systemic drying up of the credit markets (the "credit crunch"). This drove the world's main stock indices into 50 percent declines and caused scores of leading financial institutions to either crumble or restructure.[12] To the extent that the prices of art are uncorrelated to these developments, one would expect art funds that bought shrewdly in the period leading up to this crisis to be well prepared to weather these conditions. At best, the logic goes, art prices may rise as investors transfer their money into cash and unleveraged real

assets such as art and commodities like gold and silver. At worst, art should hold its value better than conventional assets such as stocks and bonds, especially in an inflationary environment where irreplaceable hard assets tend to outperform the broader market: company shares might become worthless, but a Canaletto, as FAF's cofounder and CEO Philip Hoffman underscores, "will never fall to zero."[13] In addition, irrespective of the art economy's globalization, it remains a fragmented and hybrid market, meaning that price discrepancies that beset one sector may not be apparent elsewhere: values in the United States and Britain may depreciate, but the same may not occur in India or South America and savvy, well-structured art funds should be able to take advantage of these differences. And lastly, an economic downturn may actually provide an attractive opportunity for savvy investors to stockpile artworks at depressed prices.

Art funds also compare attractively to galleries in several respects. For one, they are capable of having lower cost-bases and overhead: they save on real estate by not having to pay for large exhibition spaces. Second, their concentration of financial and art market expertise across numerous market sectors should, if organized efficiently, exceed the competencies of most galleries, which are often more specialized.[14] Third, the large capital base sought by art funds gives them a purchasing power that eclipses that of gallerists, who tend to be poorly financed due to high operational costs and the continuous reinvesting of business profits. Hoffman emphasizes this point: most galleries and private dealers are severely cash strapped, with only a very small minority having above $10 million of investable assets, and hardly more than a handful in excess of $100 million.[15] (By contrast, we should recall that at inception Fernwood and FAF sought to raise $150 and $350 million, respectively.) Finally, and owing in part to these capital limitations, most dealers tend to turn over their assets rapidly: they attempt to buy at a deep discount and resell as quickly as possible (ideally purchasing, or holding on consignment, only with a particular client in mind). However, because funds have longer investment horizons of up to a decade, they can undertake potentially more advantageous "buy and hold" investment strategies. This insulates them from short-term fluctuations in the market, allows them to offset steep transaction costs (which can be amortized over a number of years), and also broadens their buying universe beyond the scope accessible to most dealers, especially for works that are either riskier or selling at a only modest discount (both of which the fund can buy and set aside for a number of years in the hope that the market will turn in their favor). Art funds are thus capable of delivering significant liquidity to the marketplace. This feature, coupled with their proposed ability to identify and invest in opportunities quicker and more fluidly than competitors, underscores their promising strategic position.

Today's art funds are set up essentially like private equity or hedge funds, a major departure from earlier initiatives, which tended to be run as syndicates or private partnerships and hardly offered the same range of structured investment solutions. They aim to securitize the buying and selling of art by giving accredited individual and institutional investors exposure to the art market through shares in a fund.[16] Most are structured as five- to ten-year closed-end investment vehicles, meaning that, unlike the more liquid market for stocks or mutual funds, investors are able to purchase shares only until a certain point at which the fund is "closed."[17] Their capital is then "locked up" with the fund and shareholders can redeem their equity only at preallocated intervals (e.g., quarterly or annually) or at the end of the fund's term as it is drawn down. Investors typically contribute a minimum of between $100,000 and $250,000 to the venture, for which they pay a "2 and 20" fee: the fund's management company deducts 2 percent of committed capital per year to cover overhead and operational costs and also takes a 20 percent performance fee on earnings, usually above a hurdle rate of between 6 and 8 percent.[18]

Also like private equity and hedge funds, while most art funds operate out of offices in the United States, Britain, and continental Europe, they tend to be registered in offshore domiciles such as the Cayman Islands, Channel Islands, British Virgin Islands, Bermuda, and Luxembourg. These investor-friendly jurisdictions have low levels of regulation and attractive tax regimes that enable such funds to optimize their investment returns. Americans, for example, are required to pay a steep 28 percent capital gains tax on art and collectibles (versus 15 percent on real estate and securities), yet a BVI-registered art fund is more efficient for investors because there are no capital gains taxes here at all; the difference can then either be reinvested in further art purchases or distributed as a dividend to shareholders.

Art funds' capital and investment return targets can vary greatly based upon their objectives, management structure, and financing. Some funds, like Fernwood and FAF, aim to raise hundreds of millions of dollars, whereas many fall into a more moderate $15 to $50 million range. Performance objectives can vary, too, though most funds seek returns of 10 to 15 percent per annum net of fees.[19] Once the money is raised, or at least once enough money is secured to begin investing on an initial tranche of capital before the fund is closed, the fund starts to purchase artworks. For a ten-year fund, investments generally will be made in years one to four, with divestments occurring in years three to ten. Some funds may try to grow their capital base in the early period by buying and reselling

rapidly and reinvesting proceeds into further purchases; after a certain mandated point, generally around year three or four, the fund will no longer be able to make purchases but will hold inventory until an optimal sales opportunity is identified.

Art funds' cash flows need not be limited to their core investment business. They may monetize the value of art in their inventory by renting it to investors in the fund or by loaning it to exhibitions.[20] Investors with FAF, for example, can borrow works owned by the fund at a cost of 1.25 percent of their appraised value. And exhibition loans, especially to prominent museums, can be a smart way for funds to actively manage their asset base: storage and insurance costs are reduced (which would typically be covered by the exhibiting institution) and provenance is added to the artwork (which should theoretically boost its resale price). In addition, funds may leverage their art market expertise by consulting for private collectors or financial institutions. Hence alongside its four investment vehicles, FAF has an art advisory relationship with BSI Bank in Switzerland and Banco Santander in America through its wholly owned subsidiary, Fine Art Investment & Research Limited, Inc.

Most funds apply a multitiered management structure. At the apex is a senior management team or investment committee comprised of the funds' founders, chief investment officer, and other reputable advisors. This group, often with strong auction house and finance backgrounds, dictates the funds' scope and vision, raises capital, assists in the due diligence process, and is the chief mouthpiece to investors, the media, and the art and financial communities. Trading is usually executed by a well-placed team of external art buyers. These tend to be practicing gallerists, private dealers, and ex-auction house specialists; they are experts in the field, have extensive client contacts, and are able to identify, source, and trade artworks with the funds' financial backing (optimally with a resultant trade discount). Unlike senior management and administrative support teams, the art buyers tend not to be on the firms' monthly payroll. Instead, they usually receive commissions for placing work with the fund as well as carried interest in the funds' performance. Art advisors may also intermediate between the buyers and management; these are often either critics, academics, or retired art market specialists used to provide objective oversight on trading decisions.

Fernwood's proposed eight-step investment strategy was exemplary of this: (1) determine overall allocation; (2) assess liquidity and cash deployment; (3) employ investment analysis expertise; (4) identify and source potential opportunities; (5) perform due diligence and negotiation; (6) determine portfolio suitability; (7) execute transactions; and (8) continually reassess cash and exposure. The goal, in other words, was to apply "seamless and ongoing" active management to optimize investment returns.

Art funds typically deploy three main investment strategies. The first is a "diversified" strategy in which investments are made across multiple geographical markets and market sectors—from Old Master and Impressionist painting to contemporary art. Another is a vertically integrated "region-specific" strategy—for example, a Chinese art fund composed of porcelain and antiquities as well as work by living artists. And a third is an "opportunistic" strategy that seeks to profit through distressed sales and informational asymmetries arising in the wider art market (e.g., buying at a significant discount from the inheritor of an estate who may want to quickly convert their art to cash). Most funds are based on one of these three general strategies or some hybrid thereof.

A good representative example is provided by the Fine Art Fund I, FAF's first investment vehicle, launched in 2003. FAF I was conceived as a diversified fund specializing in five market sectors (optimal allocations in parentheses): Old Masters (25–30 percent), Impressionist (30 percent), Modern (20 percent), Contemporary I (1960–85, 15–20 percent), and Contemporary II (1985–2010, 0–5 percent). Its art buyers are leading experts in each respective sector whose tasks are to introduce work to the fund, oversee its purchase, and, often, its resale.[21] Once a promising item is identified, an art advisor vets the proposal and puts forward a recommendation to FAF's management, led by Philip Hoffman, which in turn undertakes due diligence of its own. Its works vary in price—beginning in the mid-five figures to several million dollars—but no single item costs more than 15 percent of the fund's committed capital, and any purchase greater than 7 percent of its commitments requires approval by the Fund Board. Investors allocate no less than $250,000 to the fund and are charged a 2 percent management fee and a 20 percent performance fee after a 6 percent hurdle. The fund has a ten-year duration, with the option of two additional one-year extensions, and returns cash to investors from the end of year four onward (once it is no longer buying works). Its sophisticated structure and ambitious business strategy make it exemplary of how far art investing has come in recent years and give us a platform to critically engage with both the history and future trajectory of the practice.[22]

Origins

Interest in art investing may be escalating, but it is hardly new. Art historian David Solkin has discussed the emergence of paintings as objects of "widespread capital investment" in eighteenth-century England and Peter Watson, in his excellent book on the formation of the modern art market, has cited Baron Friedrich von Grimm, also in the eighteenth century, as

advocating that "purchasing paintings for resale was an excellent way to invest one's money."[23] Preeminent Cubist dealer Daniel-Henry Kahnweiler stretches the history of art market speculation further yet, pointing out that the Marquis de Coulanges, in the seventeenth century, said that "paintings are as valuable as gold bars."[24] Yet despite these roots, the figure of the art investor as we know it today had not truly emerged even by the late nineteenth century as bourgeois-entrepreneurial capitalists laid the bedrock of the modern art market: investments were still principally made to enhance social prestige, not to reap explicit financial reward.[25]

The most famous early example of a business conceived to invest in art is the Peau de l'Ours (Bearskin) art club, established by financier André Level in Paris in 1904. It consisted of thirteen partners, including Level, who each contributed 250 francs annually to a pooled trust, which was used to invest in modern artworks. It has been described, presumably unbeknownst to Steinberg, as the "first mutual fund in modern art."[26] In total, Peau de l'Ours purchased approximately one hundred items over a ten-year period. The entire collection was then auctioned at Hôtel Drouot, Paris, on 2 March 1914, generating sales of 100,000 francs, or nearly four times the original outlay. Picasso's *Saltimbanques* (1905) was the most expensive item, selling for 12,500 francs against an original purchase price of 1,000 francs in 1908. Yet despite this apparent success, the onset of the First World War, followed by the Great Depression and eventually the Second World War, meant that this precedent failed to gain headway; the next wave of art investment activity would not emerge until the 1970s.[27]

The concept of art-as-investment has evolved significantly over the past century. During the first half of the 1900s, few commentators emphasized the correlation between the art and financial markets or noted art's potential attractiveness as a financial hedge—key criteria nowadays. Reporting instead focused on how rising prices heralded art's investment potential.[28] There is a suggestive distribution in these writings, too: prior to 1970, journalism on art investment is concentrated in the early to mid-1930s and again during the 1960s.[29] This is consistent with the publication of Rush's aforementioned *Art as an Investment* in 1961 as well as the increasing focus on the subject in the popular media. Germany's *Der Spiegel* allocated the cover of a 1966 issue to the debate (with the headline reading "Art as Investment"), and German business magazine *Capital* launched its heralded *Kunstkompass* artist-ranking guide in 1970.[30] One explanation is that the aftershocks of the Great Depression and transition into the New Deal era mobilized discourse in the former period, while the inflationary lag from the mid-1950s, the stock market crash of 1962 and the eventual recovery of the art market during the 1960s drove the latter. This substantiates the aforementioned point that

art's intrinsic value makes it especially attractive during periods of high inflation as well as the notion that interest in art can rise during periods of financial and political turmoil: art as a reserve of unassailable meaning in difficult times.[31]

The watershed study of historical art prices is Gerald Reitlinger's *The Economics of Taste*, published in three volumes between 1961 and 1970.[32] His data set of some 5,900 painting and objets d'art sales from 1700 to 1961 added a formerly unprecedented level of quantitative rigor to the literature and his assertions were unambiguous: "By the middle of the 1950s, after two world wars, a world financial depression, and a world wave of currency inflation, 'art as an investment' had lost any stigma that it might once have possessed."[33] Mere euphoria over sales prices had thus been replaced with a judicious blend of quantitative and qualitative judgment; "art as an investment" was correlated with art's utility as an inflationary hedge.

Reitlinger's conclusions begat a more sophisticated approach to the subject of art investing that led, in the current period, to the grafting of modern finance theory onto the art market. This will be discussed below. Here it is revealing to observe that the earliest institutional art investment funds were inaugurated only shortly after Reitlinger's study and occasionally made explicit reference to his research. The British Rail Pension Fund (BRPF) is the shining case in point, but there are other examples, too. In 1970 Baron Leon Lambert founded Artemis in Luxembourg, while the following year Ephraim Ilin incorporated Modarco (Modern Art Collection, S.A.) in Panama on $5 million and $3 million investments, respectively. The two were inaugurated as pure trading concerns—Artemis even likened itself to an "Art Investment Banking Firm"—a strategy that suited both visionaries—Lambert, a banker; Ilin, an industrialist.[34] Within its first year, however, Artemis lapsed from fund into a publicly traded dealership and continued to operate as such until its eventual closure in 2006; Modarco's investments began losing money in 1974–75 and the company merged with fine art dealer Knoedler in 1977.[35] During this period, other similar ventures either went public and floundered shortly thereafter (e.g., the Sovereign-American Arts Corporation, founded in 1968 and listed on the National Stock Exchange in 1970), withdrew applications from the U.S. Securities and Exchange Commission before they ever reached this stage (e.g., the Art Fund, founded in 1969, and Collectors Funding), or remained discreet private ventures (e.g., the John Adams Fund, Inc. which invested in Impressionist and post-Impressionist art).[36]

In fact, none of these businesses would survive in their original form by the end of the 1970s. In 1985 the *New York Times* simply reported that "The mutual fund approach to art, a hot idea during the art boom of the 1970s, has no survivors."[37] This testifies to the weak historical track record

of art investment funds and must not be forgotten as the practice undergoes its renaissance.

British Rail Pension Fund

BRPF is the only major art fund to survive the 1970s. One key difference between this fund and its contemporaries was that it was not just a product of the then buoyant art economy but was launched as an innovative way to hedge the double-digit inflation triggered by the OPEC-led oil crisis of 1973, which significantly weakened the equity and commercial property markets and the value of the British pound.[38] Business objectives were long term (spanning twenty-five years), and the rationale was that if precious metals were regarded as financial safeguards, why not art?

Fund director and visionary Christopher Lewin cited Reitlinger and concluded that most categories of art had proved sound long-term investments and that between 1920 and 1970, only returns to tapestries and arms and armor had failed to match inflation: "The risk element is not as great as you might think. Demand will increase, supply won't ... we could be international in buying goods without any problems of foreign exchange regulations.... I had very good reason to suppose that works of art would be an excellent hedge."[39] Lewin thus recommended the annual expenditure of up to 6 percent of BRPF's annual cash flow on art (around £3 million per year), and between 1974 and 1980 BRPF invested across diverse market sectors (painting, sculpture, books, furniture, bronzes, jewelry), ultimately allocating £40 million to some 2,400 items.[40] Moreover, by directing no more than one-third of its funds to Old Master paintings and drawings and by limiting Impressionist exposure to 10 percent, the directors felt well suited for long-run gains. BRPF stopped purchasing art at the turn of the decade once its collections were sufficiently diverse and inflation had cooled.[41]

The fund began divesting its art portfolio in June 1987. This decision was prompted by several factors: first, the strong art market at the time provided a good climate for optimizing investment returns; second, more suitable investment avenues had become available by this point than when the art investment strategy was first implemented in the 1970s (i.e., index linked bonds); and third, there was a growing awareness of art's high maintenance costs and the difficulty of continuously and accurately valuing such a broad collection.[42] Ironically, although these sales meant that British Rail would be disregarding its long-run strategy, they also proved to be the most profitable.

Through 1988 the fund had offloaded about a thousand items for approximately three times their initial cost.[43] More notably, when the fund

liquidated a collection of its Impressionist paintings in April 1989, it collected £34.9 million, against an initial £3.4 million outlay, for an impressive 21.3 percent annualized investment return. Chinese porcelain sales in May and December 1989 were also profitable, netting £10.5 million against a £1.6 million purchase price, for a 15.4 percent cash rate of return.[44] But other investments appreciated at inferior rates. Primitive art and furniture were notorious laggards, while an otherwise "fine group" of Old Masters sold in July 1996 translated into a real loss of 0.4 percent per annum.[45] The cumulative performance of BRPF's art portfolio, through the final liquidation of its assets in 2000, reflects these weaker results and lies at an overall cash IRR of 11.3 percent, or 4 percent per annum in real terms after allowing for inflation.[46]

BRPF is typically enlisted as a successful precedent, especially by art fund enthusiasts. The ultimate objective of its art investment strategy was to beat inflation, which it achieved through the careful purchase and sale of certain core artworks. Yet its results were not unilaterally encouraging. First, though its returns to art outpaced inflation, they underperformed those of the major stock markets over the investment period.[47] Second, BRPF was fortunate to offload its Impressionist paintings during an unprecedented boom in this sector, and it therefore benefited from circumstances that new funds cannot be expected to replicate. Third, because trading decisions had to pass approval from an art subcommittee, time delays were at times unavoidable and liquidity issues proved burdensome: attractive buying opportunities were forgone due to administrative impediments. Additionally, despite a strategic agreement with Sotheby's, the auction house served principally as collection advisor and offered only minimal reductions in the buyer's premiums and seller's commissions. Transaction costs were consequently substantial—approximately 5 to 7 percent to buy and sell—and considerably diminished the fund's bottom line. It has been alleged that the auction house sold poor-quality works to BRPF, "especially those it owned or on which it had provided an advance or a guarantee," a detrimental conflict of interest that will resurface in the discussion below.[48] The cost of insurance was also significant. While BRPF understood the importance of lending to private collections and museums to boost provenance and divert these premiums (applied to the borrower), many of its holdings remained in storage throughout the venture; they were either too fragile to loan or mandated special display conditions that made such loans infeasible.[49] BRPF thus bore the full price of insuring such goods, which in conjunction with the aforementioned factors diminished the fund's investment returns.

Post-BRPF art investment ventures have struggled even more. At the peak of the 1980s bubble, Chase Manhattan Bank solicited $300 million of investments from pension funds for a closed-end art fund but failed to

raise the necessary capital and shelved the venture before it ever got off the ground.[50] And between 1989 and 1991, Banque Nationale de Paris (BNP) allocated $22 million toward the creation of two art funds of its own. Hundreds of investors participated, but when the works were auctioned in 1998 and 1999, the fund absorbed losses of more than $8 million. Not only did BNP invest at the top of the market, but its duration was too short and executives have since lamented the "rigidity" of its operational structure, a claim that echoes a shortcoming of BRPF.[51] English outfit Taylor Jardine, established in 1998, offers a different example. Aspiring to buy and lease paintings to corporations, the venture purchased over 1,900 works and optimistically projected returns at 10–15 percent per annum. The firm was liquidated in 2003, claiming losses of £6.4 million, after it was unable to loan more than three hundred items. Britain's Department of Trade and Industry shut down a similar scheme, Barrington Fleming Art Society, in March 2001.[52]

In Theory

Interest in art funds abounds despite this unremarkable history. One reason is due to the market's extraordinary strength for much of the post-2000 period—rising prices bolstering the impression that art is a lucrative financial asset. Yet the most significant factors are the heightened theoretical credibility of art investing, the growth of the alternative investment industry, and the range of structured solutions now offered by art funds.

Today's art funds, unlike their predecessors, draw upon a barrage of recent economic literature to convey the merits of art as an alternative asset class. Fernwood, for example, hired Ph.D. economist Robert Gough as its chief economist and published an array of financially sophisticated marketing materials, replete with whizzy charts, graphs, and academic citations. Since 2004 FAF has both sponsored and participated in seminars under the title "Art: An Alternative Asset Class."[53] These sessions have incorporated notable art and financial market professionals such as Daniella Luxembourg of ArtVest, Citibank's Mary Hoeveler, and economists Michael Moses and Rachel Campbell and aspire to demonstrate the benefits of investing in art.

The inclusion of Moses, former professor at the Stern School of Business, New York University, and Campbell, associate professor of finance at University of Maastricht, is exemplary of this new paradigm.[54] In "Art as Investment and the Underperformance of Masterpieces," published in 2002, Moses and Jianping Mei found that between 1875 and 2000 the average annual *returns* realized by art goods were between those of equities and bonds (less than the former, greater than the latter) and possessed

lower *volatility* and *correlation* with these assets than previously estimated.[55] Their conclusion is that art can be a beneficial component of a financial portfolio. Campbell, writing in "Art as an Alternative Asset Class (2005), upholds this thesis and argues that over the longer term, and especially during extreme market movements, art can yield "significant benefits" to investors.[56]

Let us look closer at this terminology to understand exactly what is being argued. The concept of an expected return corresponds to the *average return* an asset produces for its owner. In the case of a coin toss where the owner will receive either $1 (heads) or $3 (tails) every time a coin is flipped, the *average expected return* is $2 even though the owner will never receive this sum on any throw: the *actual return* (either $1 or $3) always varies from the *expected return* ($2) by a factor of one, and the probability of either scenario is 50 percent. As this game is played, the owner expects to earn $2 per toss in the long run but must realize that actual returns may deviate from this figure in the shorter term. One million coin tosses will generate an average income proximate to $2 per throw, but ten tosses may produce an average far closer to $1 or $3: a string of heads or tails will have a significantly greater impact on this smaller sample. An asset's expected returns and the investment horizon necessary to achieve these are elemental to finance theory and feature prominently in economic literature on art trading.

Investors also need to be aware of the probability of achieving the average return at any moment. This is called an asset's risk, or *volatility*: by how much do *real* returns fluctuate around the average? Economists describe these properties in "variances" or "standard deviations" that refer to the range within which a given outcome is expected to occur a certain percentage of the time.[57] Provided a normal distribution, or bell curve, in which returns coalesce around an average and tail off equally in both directions—such as in the coin-flipping game—there is a 67 percent probability that returns fall within one standard deviation and a 95 percent probability that returns fall within two standard deviations. Therefore, the higher the standard deviation, the greater volatility and investment risk.

This can be a confusing concept, so it helps to use Mei and Moses's calculations for clarification. In a subset of their study, they observe that between 1900 and 1986, art returned 5.2 percent per annum with a volatility (standard deviation) of 37.2 percent, while the S&P 500 stock index generated an average of 5.7 percent per annum with a volatility of 20.7 percent.[58] Thus, art returned between –34.2 and 42.9 percent per annum roughly two-thirds of the time, while it returned between –70.2 and 80.6 percent per annum about 95 percent of the time.[59] Conversely, stocks returned between –15.0 and 26.4 percent, and –35.7 and 47.1 percent, within the same one- and two-standard-deviation parameters. With a

higher average annual return (5.7 versus 5.2 percent) and lower standard deviation (20.7 versus 37.2 percent), one may begin to comprehend the relative investment risks and benefits between art and equities: art appears to have a lower mean return and is more volatile.

In isolation, such characteristics do not legitimize art investment as it is assumed that rational investors will choose the least return variance for a given level of mean return: art, being more volatile and less lucrative (on average) than stocks, would therefore appear to be an inferior asset.[60] The reality is more complex, as illustrated by Modern Portfolio Theory (MPT), a profit-maximizing model for the combination of assets. Advanced by economist Harry Markowitz in 1952, MPT postulates that if the average return, variance, and covariance for individual assets within an investment basket can be quantified, an "efficient portfolio" can be created to optimize an investor's returns.[61] Key here is covariance, or the relationship of assets to one another and to a market bundle (an equity index, for example).[62] As Markowitz's judgments passed through a series of revisions and ultimately helped spawn the Capital Asset Pricing Model (CAPM), a theory concerning equilibrium asset pricing, it became accepted that in the construction of an investment portfolio, the variance of an individual asset's return is trivial; what matters is the relationship between the return of an individual asset and the return of all assets taken together (called the "market basket"). So, whereas prior to Markowitz it was generally assumed that aggressive investors should purchase more volatile assets than conservative investors, portfolio theory advocated a more complex process of asset diversification in which investment risk is spread across assets with different correlations to the market basket.

Fernwood exemplified the crystallization of this logic. In its marketing material, it urged art investments to "fall under the same broad strategic financial umbrella as other invested assets," utilizing an efficient frontier analysis to demonstrate the hypothetical advantages of so doing.[63] Over the twenty-five-year period ending 31 December 2003, Fernwood calculated that the statistically optimal portfolio consisting of 35 percent equities, 45 percent bonds, and 20 percent art not only generated superior performance to ten-year bonds (11.0 versus 9.9 percent, respectively), but also endured a risk level of only 7.7 percent, the lowest risk among all assets classes (equities, bonds, gold, and art) in the model. By comparison, a portfolio consisting of either 100 percent equities or bonds would have a less optimal risk-return profile. Echoing the lessons both of CAPM and some notable recent economists, Fernwood concluded: "Art's remarkably low and even negative correlations to other asset classes play a key factor in the model's outcome. A portfolio's efficiency can be significantly improved by allocating some exposure to fine arts."

The crux of Mei and Moses's findings therefore does not reside in art's risk-return metrics—nor, as is the common misperception, in the absolute price appreciation of artworks—but in the correlation between the price movements of these assets and those of other financial instruments: a rational investor may choose to hold art if it is believed that art prices move weakly, or inversely, to other investments in their financial portfolio. While this viewpoint may have long substantiated an intuitive case for art investing, Mei and Moses's study of 4,896 price pairs (repeat painting sales at auction) over one hundred years was among the first, and certainly the most influential, to quantitatively endorse it. These findings have since been reinforced by Campbell, who argues that not only do the U.S. and U.K. art markets have negative and low correlations with equity markets, respectively, they are less volatile than these markets as well.

It cannot be emphasized strongly enough how important it has been for these economists to lucidly translate the theoretical benefits of art investing into intelligible economic jargon. This had the watershed ability to open the art market to a world of modern, global finance from which it had long been distinct: on paper at least, art could now be championed as a dynamic "alternative" asset class. This transfixion with art's investment benefits is evident in the talismanic coverage of Mei and Moses's research in the mainstream media and Moses's numerous appearances on news networks and in conferences and discussion panels elaborating his cause.[64]

Demand

The recent growth of art fund activity is not propelled by theoretical arguments, alone, but also by developments in the art and financial services industries. One catalyst extends from the rise of the art advisory profession. Citibank's Art Advisory Service, cofounded in 1979 by Patrick Cooney (hired by Fernwood) and Jeffrey Deitch (who went on to become a prominent New York gallerist and in 2010 took over as director of the Museum of Contemporary Art, Los Angeles), may have inaugurated this field at the institutional level, but many have followed suit.[65] Since the 1990s Chase Manhattan, Coutts, Credit Suisse, Deutsche Bank, Bank of America, and UBS have all launched similar business units in an attempt to win and retain the business of financially elite art collectors, and ABN-AMRO's aforementioned art fund was to be predated by an art investment advisory service of its own.[66] Meanwhile, if the advent of Sotheby's Financial Services in 1988 marked the auction industry's willingness to furnish similar offerings, scores of specialist firms such as the

Art Capital Group, Art Finance Partners, Emigrant Bank Fine Art Finance, and Fine Art Wealth Management (FAWM) have since crowded this niche offering anything from loans against art to varied art lifestyle services.

There is a fine line, however, between art investment advice and the type of art-focused services offered by these institutions. "We don't advise our clients to invest in art," insists Francesca Guglielmino, former director of the Citibank service, "but wealthy people have art and so we have a unit for them."[67] Nevertheless, art market journalist Georgina Adam observes that "while most of the art advisory services anxiously deny that they ever advise clients to 'invest' in art, in fact they provide a great deal of information about different aspects of the market."[68] Citibank's offerings thus include an Art Advisory Service that provides clients with condition, authenticity, provenance, pricing, and market insight for acquisitions and sales; an Art Management Service that creates a photographic database of clients' collections and oversees the shipping, installing, conserving, and insuring of their art (with industry rates); and an Art Finance Service that facilitates loans, with clients' art held as collateral. The key point is that while most of these institutions do not counsel clients on art investing—FAWM being one obvious exception—their packaging of increasingly sophisticated art collection and financing services actually shares a lot of common ground with the offerings of today's art funds.[69]

Funds like FAF and Fernwood, for example, were set up to provide dynamic art financing and collection management services as well. At FAF, these include guidance on customers' personal collections, due diligence on artworks outside of the fund's own investment universe, short-term rental arrangements, loans, art financing, restoration, and coinvestment opportunities. And the fund is also the chief art advisor to the private wealth clients of BSI Bank and Banco Santander. Fernwood was poised to furnish a similar bundle of offerings—encompassing "Quantitative Econometric Research and Analysis," "Market Intelligence Gathering," "Collective Behaviour Analysis," and "Economic Analysis and Forecasting"—alongside its art investment portfolios. If managed efficiently, these would have rivaled, and possibly exceeded, the competencies of other leading art finance businesses.

These aims dovetailed with the liberalization of the art trade aspired to by Taub:

> The securitization (perhaps a better term would be "democratization") of previously illiquid investment categories is a steady, ongoing trend that has gained momentum with the spread of global capitalism, to the benefit of increasingly wider groups of investors. These benefits are typically enjoyed first by a small, privileged group of insiders, then by a wider group of sophisticated investors, and finally become retail investment opportunities available to all. Equities and bonds made this journey over the last century, and funds-of-funds are now making more non-traditional investment categories (such as hedge funds and private equity investing) accessible to individuals with smaller and smaller amounts of capital to invest. I believe that art is heading down the same road, to the eventual benefit of all investors.[70]

Rising wealth levels among the world's financial elite and their accelerating demand for alternative assets and lifestyle amenities created a receptive backdrop for just such a transition. This reflects what economists call positive income elasticity of demand: the wealthier people become, their demand for luxury goods (or "nonessentials") such as art rises more than proportional to their income increase.[71] And in recent years there has been both an extraordinary concentration of wealth in the pockets of accredited high- and ultrahigh net worth individuals and a more sophisticated understanding of how they spend their money on "passion investments."[72] Fernwood's founding vision of 2004 explicitly cited the importance of the growing HNW demographic to their business prospects, and it also plays a key role in the focus of virtually all current art funds.[73]

CapGemini and Merrill Lynch's *World Wealth Report* substantiates this upward trend: at year-end 2007 HNW wealth totaled $40.7 trillion, and it is believed that this figure will reach $59.1 trillion by 2012.[74] In this same study, art ranks only slightly behind luxury collectibles (private jets, yachts, and high-end cars) in HNW's investments of passion and is considered relatively insulated from the adverse affects of the tumultuous global economy.[75] I will address this supposition more critically in the conclusion, but it is most important in the present context to understand the central role of art in the expenditures of this growing universe of financially elite investors.

The increase of alternative asset investments held by HNWs also alludes to the prospects of art funds.[76] By 2005, for example, alternatives comprised 20 percent of HNWs investment portfolios, up from just 3 percent in 2000.[77] This surging popularity was epitomized by the wondrous growth of the hedge fund industry. Like art funds, these investment vehicles are not new: the first hedge fund was founded in 1949 by Alfred Winslow Jones, who introduced the then groundbreaking concept of hedging investment bets.[78] Through strategic trading (often short selling), and extensive borrowing (leverage), hedge funds attempt to exploit market mispricings that other, more traditional investment vehicles, such as mutual funds, cannot logistically, or legally, pursue.[79] Economists William Goetzmann and Stephen Ross describe this as follows: "[Hedge funds] pursue strategies that can be termed 'arbitrage in expectations,' or

expectational arbitrage. That is, they seek to provide a positive expected return on capital with a minimal exposure to systematic sources of risk by 'hedging away' exposure to traditional asset classes typically held in the investment portfolio."[80]

Exceptional results were achieved through this strategy, especially early on. From 1962 to 1966 Jones outperformed the top mutual funds by more than 85 percent, net of fees. A 1968 U.S. Securities and Exchange Commission survey reported the existence of 140 such funds, a figure that has grown tremendously ever since. Although it is difficult to quantify the growth of this industry (hedge funds are not legally obliged to disclose assets under management [AUM] or earnings), it is estimated that 1,000–2,000 existed by 1990, representing approximately $38 billion in invested assets. By 2003 this had escalated to 8,000 funds and $800 billion in assets; and by 2008 it was estimated that there were 11,700 hedge funds with $1.7 trillion AUM (numbers that have since tailed off in the wake of the global economic crisis).[81]

Art funds have not only benefited from rising interest in hedge funds. The popularity of other alternative investment vehicles, such as real estate investment trusts (REITs) and private equity funds, is also critical, and many art funds envision themselves as hybrids of these businesses.

This is deliberated in a 2004 case study on Fernwood published by the Harvard Business School (HBS). The study quotes Todd Millay, senior consultant to Fernwood, as describing art as being "on the same journey that real estate took over the last few decades."[82] REITs date from the late nineteenth century, but they did not take their current form until the passage of the Real Estate Investment Trust Act in 1960. With this legislation, these trusts, which enable investors to purchase shares in a pooled group of properties, were exempted from corporate income taxes if they adhered to criteria such as establishing lower minimum investment levels. Following the passing of the 1986 Tax Reform Act (allowing REITs to manage their properties directly, without third-party oversight), the opening of REITs to pension funds in 1993, and the 1999 REIT Modernization Act (permitting them to provide specialized management services to tenants), there were nearly 150 publicly traded REITs managing $200 billion in the United States by the end of 2009.[83] Like REITs, art funds give investors exposure to a bundle of assets for a lower capital outlay than otherwise possible.

Private equity funds, which purchase stakes in private companies in hopes of reselling them at higher values, offer a notable point of comparison as well. "The private equity model," observes the HBS study, "[is] similar to Fernwood's in that the end goal of both models [is] 'asset appreciation.' Private equity investment style [is] not based on portfolio management; instead it focused on singular transactions and eventual repayment to investors after a specified amount of time (usually 10 years)."[84] This explains why art funds are keen to loan works to enhance provenance and reduce insurance costs. But similarities do not end here: FAF's ten-year closed-end limited partnership is indebted to private equity funds' characteristic decade-long lifecycle as well, as the aforementioned "2 and 20" fee structure resembles that of both private equity and hedge funds. And similar to other alternative investment vehicles, the marketing jargon of today's art funds heavily underscores its managers' past track records, as many are also run out of the major financial centers like New York and London but registered in investor-friendly jurisdictions such as the Bahamas and British Virgin Islands.

Hedge Funds

Art funds can be put into further context by exploring some comparisons with the hedge fund industry. Despite the assets amassed by hedge funds and their extensive media coverage, their overall size is actually less than 1 percent of total financial assets, globally—measured by the combined market capitalization of stocks, bonds, and bank savings. Even upon accounting for leverage, they still do not control more than 3 percent of the world's financial assets.[85]

The field of art investing constitutes a similar relative position: considerable media coverage has been complemented by only a marginal financial impact on the art economy. Recent estimates indicate that the global art market, comprising both auction and private sales, amounts to approximately $50 billion versus projected AUM of $350 and $150 million for FAF and Fernwood, respectively.[86] Over the expected ten-year life cycle of these funds, this equals $700 million and $300 million in total turnover (buying and selling), or an average of $100 million annually ($70 million for FAF, $30 million for Fernwood). Assuming there are ten additional funds with AUM of approximately two-thirds that of Fernwood (at $100 million each, or $20 million in annual turnover—recall that FAF and Fernwood are reported to be the *largest* such businesses), this would constitute an additional annual turnover of roughly $200 million. The annual turnover of art funds thus approximates $300 million ($100 from FAF and Fernwood, $200 from the remainder of the industry), or merely 0.6 percent of the value of the $50 billion international art market in 2009. Furthermore, projecting that the global art market grows at the rate of inflation (3 percent) while the turnover of such art funds increases at an aggressive 15 percent per annum (thus assuming that fund returns meet the top end of their investment guidance), even a decade hence (2018), the market share of these vehicles equates to just 1.6 percent.

These figures are admittedly misleading. Because of the high volume and rapid turnover of their holdings relative to traditional "real money" investors, hedge funds actually constitute a much larger degree of trading volume than their market share suggests. They can account for a majority of trading on certain assets, and their high levels of leverage (which were known to exceed ratios of 30 to 1 during the bull market) can have a huge impact on financial institutions globally, as became acutely evident during the credit crisis.[87] Art funds may display similar characteristics. Because they are mostly managed out of New York and London, their presence in these markets may be disproportionate compared to the global trade; ditto their presence in Western postwar art, which is a strong component of many such funds. Additionally, and most notably, the actual size of the art fund universe is far smaller than suggested above: Fernwood no longer exists, FAF raised less than a third of the $350 million it originally sought, and only a small handful of additional funds were in existence by the end of 2009 (see appendix C).

There are also a number of caveats to hypothetical investment returns. Because hedge funds are exempt from SEC registration, reporting, and regulation, performance is difficult to quantify. In fact, those who report performance tend to possess the best track records: the most successful funds publicize returns while those that perform poorly, or fail, proceed undocumented. This is known as "survivorship bias" and may overestimate returns of a hedge fund index by as much as 2 to 3 percent. "Backfill bias" is also prevalent and can inflate performance statistics as well.[88] Furthermore, astonishing track records of a small number of funds may produce misleading statistics on average returns.[89] In summary, if and when one is able to quantify the art fund industry's performance, these factors will figure prominently, and one suspects that the success of a few such businesses may overshadow the industry's more humble aggregate profile.

In addition, the etymology of alternative investing is slippery. Where "alternative" once referred to assets on the fringe of the investment frontier, it has come to constitute a linguistic catchall for increasingly transparent and liquid ones. A corollary question is thus: as such investment devices become mainstream, do their perceived economic benefits increase, remain constant, or diminish?

Evidence suggests that returns across the alternative investment frontier are lessening. One consequence of the hedge fund industry's growth since the 1990s, for example, is the confluence of rising liquidity and diminishing returns. Such are the characteristics of an economic cycle, and where alternative once meant high risk, high return, the most popular hedging strategies now possess correspondingly weaker investment prospects. From 1998 to 2004 the ability of hedge funds to profit from two of the most basic mispricing opportunities in the equity markets deteriorated substantially.[90] Goetzmann and Ross have also discovered an overall drop in hedge fund profitability, from returning 13 percent annually between 1989 and 1994, down to 8 percent annually between 1994 and 2000.[91]

It remains to be seen whether similar dynamics will unfold in the art fund universe. Yet it seems reasonable to assume that the profound increase in the availability of art information over the past decade—hugely abetted by online sales price databases—has reduced available arbitrage opportunities. This is an especially curious phenomenon, for on the one hand this development has enabled increasingly sophisticated arguments about the financial benefits of art investing to take shape; and yet on the other hand, the very availability of such information may restrict funds' investment prospects (the more people know, the smaller asymmetries in the market will become). If financial returns diminish as the industry expands, then a crucial issue for funds moving forward will not only concern how well they sell the art investing vision but how capable they will be at demonstrating to investors that this is no mere passing fad.

Lastly, similarities to hedge funds suggest that art funds may also have a high burnout rate and, even more fundamentally, that they may suffer from a severe lack of funding in the near to medium term as investors shift into more conservative investment strategies in the face of the global financial crisis. Under ordinary circumstances, Goetzmann and Ross calculate an annual hedge fund failure rate as high as 20 percent, and the investment research firm Sanford C. Bernstein & Company estimates that 40 percent of such vehicles cease to exist after five years.[92] The credit crisis has exacerbated this, and since 2008 the industry has been ravaged by a combination of poor investment returns, escalating redemptions, and greater levels of regulatory scrutiny, which have caused many funds to close and a great many others to dramatically scale back their operations. It is estimated that in 2008, the size of the industry halved to approximately $1 trillion under management, a finding in synch with hedge fund magnate George Soros's remarks before Congress in November 2008 that the industry would shrink by half to three quarters from its peak of nearly $2 trillion; Barclays Capital has subsequently said that 70–80 percent of hedge funds will shut.[93] This has severe implications for art investing as a drain on capital to these funds will make it extremely challenging for art funds to secure the necessary level funding they require to get off the ground.

Challenges

Notable economic studies may endorse art investing, but this has not always been the case.[94] Princeton economist William Baumol's seminal

paper of 1986, "Unnatural Value: Or, Art Investment as Floating Crap Game," offers an excellent point of comparison. Although this was not the first article of its kind—earlier and oft-referenced art investment analyses include those of Robert Anderson (1974) and John Picard Stein (1973, 1977)[95]—its ingenuity, coupled with the time of its publication during the 1980s art market boom, helped to elevate interest in art's financial prospects. "Unnatural Value" does not compute correlations between art and the financial markets, but its survey of 640 repeat painting sales from 1652 to 1961 offers sound perspective nevertheless. Having achieved a real annual return of merely 0.55 percent per annum over this period, Baumol concludes that the probability of a acquiring a "good" art investment is akin to a gambling crap shoot: "In comparison with government securities, [such returns] imposed an opportunity *loss* upon the hold of the painting of close to two percentage points per year." Furthermore, because art price movements appear to be random—Baumol equates this to the 'random walk' metaphor of the stock market—he challenges the ability of investors to profit "with any degree of reliability."[96] This is an obvious affront to the art fund business model.

Goetzmann's research on historical art investment returns also dampens the allure of art as an asset class. Over the period 1716–1986, he finds that real art returns of 2.0 percent per decade outpaced those to stocks (0.2 percent) but were less than those of bonds (3.1 percent) and considerably more volatile than both of these assets (56.5 percent volatility for art versus 19.6 and 9.3 percent volatility for stocks and bonds, respectively).[97] This high volatility, in conjunction with art's "strong positive correlation" to other assets, suggests that "it is unlikely that art was a superior investment" over this period: art is a "poor vehicle for the purposes of diversification."[98]

Goetzmann is likewise critical of the repeat sales regression (RSR) methodology widely utilized to quantify historical art returns (the Mei/Moses Index is based on a RSR, as is Goetzmann's own 1993 article, among many others). The RSR identifies the investment returns of an asset sold more than once and is attractive for use in the art market because it identifies how particular works appreciate (or depreciate) over time. It is nevertheless subject to numerous limitations. First, by only accounting for resales, the RSR is limited to a small subset of the art trade and is a poor instrument for establishing financial returns over short investment periods (unless the number of resales is sufficiently large). Second, it presents a strong upward bias as decisions by an owner to sell may be conditional upon whether the perceived value of the artwork has increased. Third, the RSR requires homogeneity by assuming that damage and/or deterioration of an artwork has not occurred. And lastly, it fails to capture price fluctuations of artworks not broadly in demand, or others that have been removed from circulation.[99]

There are alternatives to the RSR, the most popular of which is the hedonic regression.[100] This model accounts for the heterogeneity of assets and measures the performance of a grouping of unique goods based upon shared characteristics. In the process of its development, it has benefited real estate and consumer product research and, more recently, the art market: because artworks possess identifiable variables (the artist's name, date of execution, dimensions, signature, medium, etc.), the hedonic regression is a useful step in accounting for product differentiation within a price index. This methodology reconciles some of the RSR's limitations by accounting for heterogeneity and by incorporating a larger sample set.

Yet despite its rising popularity, it is not flawless. The hedonic index is unable to account for the impact of damaged goods and it assumes that the given variables explain all inherent price movements. This becomes problematic, for example, if an artwork's constitutive elements are not easily attributable or if such characteristics change over time (e.g., through deterioration). This is why the hedonic regression is usually implemented to chart the financial returns to paintings and prints, whose characteristics tend to be the most standardized.[101]

These hindrances are evident in the lack of consensus as to what the financial returns to art actually are. Art market economist David Kusin simply observes that an "'all art index' is meaningless."[102] When applied to identical data sets, the RSR and hedonic regressions may also produce different rate of return estimates.[103] Moreover, because much of the literature does not account for the impact of unsold lots at auction or for transaction costs, art investment risks and returns may in practice be different from what these studies indicate.[104]

A further limitation of this research is that it only concerns sales at auction, a sector that accounts for roughly half of the global art marketplace: the financial ramifications of dealer and private party sales remain largely unaccounted for in the literature.[105] This is not fundamentally problematic—much economic analysis is derived of sample data sets—but because of the dealer market's opacity, it is difficult to quantitatively account for price characteristics of artworks here or for correlations between this and the auction sphere.

This shortcoming is compounded by the fact that art in the vast majority of these studies (including those by Baumol, Goetzmann, Mei and Moses, and Campbell) actually entails only paintings and is often drawn from a small subset of the market as a whole.[106] For example, while Mei and Moses's research has been key to expounding the benefits of art as an asset class and, consequently, to the recent growth of art investing, it

is also controversial: their data set only looks at repeat sales of paintings at Christie's and Sotheby's in New York. Leaving aside these economists' importance to the literature, this is an undeniably thin and highly selective slice of the international art market. We are given no sense of the investment characteristics of nonpainterly artworks, and there appears to be a strong upward bias in their conclusions as they evaluate the price levels of artworks only at the peak of the market (in other words, they neglect the enormous universe of art that never makes it to the two main U.S. salesrooms or only sells once at auction).[107]

Moses's subsequent retirement from NYU and his founding, in 2007, of Beautiful Asset Advisors, which gives fee-paying subscribers access to proprietary art market research, raises further questions about such biases.[108] The fact that the Mei/Moses Index is now a trademarked business (The Mei Moses™ Fine Art Index) may color its founders' position: Mei and Moses now have a clear vested interest to sell their product and investment services. Similarly, moral hazards may arise when academic economists appear on panels about art investing sponsored by art funds and art financial services firms eager to promote the legitimacy of art as an asset class. At the very least, critical remarks on the subject are apt to be kept to a minimum. Perhaps most fundamentally, then, while it is important to recognize the significance of this ever-expanding body of literature to our understanding of international art markets, it is equally imperative to keep it in perspective. Such research has certainly added color to the risks and returns of investing in art, but it is at best a theoretical guideline that continues to be burdened by its selective scope.

Another important question we must ask in relation to this is how this literature relates to the actual operation of art funds in practice? This is not easy to resolve given the discreet nature of these businesses. Nevertheless, it is unlikely that the risk/return parameters of private market investments made in distressed deals and other off-market opportunities will mirror those of the literature. Though perhaps profitable, such transactions are also apt to be riskier than an auction "market basket," and they may possess different correlations to other assets than implied. The portfolio diversification benefits of art investing suggested by the literature also have little bearing for art fund investors unless these vehicles can actually reproduce index returns. However, there is as yet no tradable art sales index for funds to invest in, while the lack of a derivatives market for art goods means that these vehicles cannot "hedge" their investments in any true sense: art funds can acquire works in the belief they will rise in value, but they cannot hold a contrarian view of the market by selling art short and betting that the price of work by a particular artist, or sector of the market, will decline.[109] This implies that art funds may be riskier than they would like investors to believe.

FAF's precedent also suggests that it may be difficult for funds to realize their proposed investment strategy. For example, FAF I was originally meant to attain a model portfolio consisting of 15–20 percent of art produced between 1960 and 1985 (Contemporary II) and just 0–5 percent of art produced from 1985 to present (Contemporary I). Yet as the fund has evolved, so has its model portfolio, with the two categories expanding to between 30 and 40 percent and 5 and 10 percent, respectively. It is therefore possible that fully *half* of the investments in this fund could be allocated to contemporary art.

This is clearly due to the buoyancy of the contemporary sector since 2000 and reflects FAF's ambition to cash in on these ballooning values. But it may also serve a logistical function that such funds do not publicly declare. Because art investing is a relatively new phenomenon, sophisticated investors are unlikely to accept the concept of art as an asset class or fund managers' past track records outright: they want to see a history of returns. In response to this, funds must rapidly turn over assets in their early stage in order to embellish their credentials and demonstrate that they are indeed making sound investments. This is to be expected insofar as such trading falls within the parameters of a fund's stated portfolio allocation. Yet the reality is that because the contemporary sector has grown so robustly and been so lucrative relative to other parts of the market since 2000, many funds, as suggested by the distribution of FAF's own holdings, may not be holding steadfast to their claimed objectives. "Sector diversification" may thus prove to be a catchy, but erroneous, byword as these funds are drawn into a vicious cycle of having to quickly generate returns in order to raise capital, ultimately exposing their portfolio to greater risk than anticipated—especially if they are caught holding large portions of contemporary art purchased at the peak of the market in 2007 and first half of 2008.

This not only applies to FAF. Prior to its closure, Fernwood was the lead sponsor of the New Art Dealers Alliance (NADA) Art Fair in December 2005, held in conjunction with Art Basel Miami Beach. This arrangement was synonymous with the firm's desire to remain "on the cutting edge of art market trends and developments," and it also fulfilled a shrewd business objective: to advance the firm's marketing campaign and to create a potentially lucrative networking platform in order to give the fund preferred access to desired contemporary works from the dealers, collectors, and artists at the fair.

These observations do not diminish the potentially lucrative investment prospects of art funds. If they raise sufficient capital from investors, their large capital reserves and extensive market knowledge could certainly enable them to exploit informational and regional asymmetries arising in the marketplace. Yet the high levels of risk they may take on to

do so underscore a fundamental schism between the theoretical promise of art investing as an academic subject of debate and how art funds actually operate in practice.

Inefficiencies

The art market's inefficiencies compound the difficulties of capturing index returns and profiting from opportunistic trading strategies. Some of the key issues are low liquidity, opaque market information, high transaction costs, and limited arbitrage opportunities.[110] The implications of these for art funds will first be examined economically and then, in the following section, sociologically.

Liquidity is arguably the most prominent of these inefficiencies and concerns how quickly an asset can be sold without disturbing prices. Art is generally seen as illiquid because there is a limited market infrastructure for facilitating sales: artworks may be in high demand but they cannot be seamlessly sold, unlike other assets like stocks, which can be traded essentially with the push of a button. Auctions offer an extreme illustration of this (where three- to six-month lapses between consignments and sales are typical), but private market transactions are time-consuming and labor intensive, and there is an ever-present fissure between these two circuits that clouds market information: auction prices are transparent but dealer prices are not.[111] In addition, many works trade infrequently and others are constantly being removed from circulation as they are purchased by, or donated to, museums—what has been called the "museum factor."[112] Because of these issues, art funds must be selective in composing their portfolios: while art's low liquidity and the lack of price transparency may present attractive investment opportunities (e.g., differences in value that funds can exploit), they also could be detrimental should funds misread market information and end up holding works no longer in high demand or should they need to divest their portfolios quickly and unexpectedly (e.g., with a sudden rush of redemptions from investors).

The economy's weak pricing system, which lacks a single generally accepted valuation methodology, is another inefficiency.[113] For example, art investors cannot simply determine the value of an artwork by calculating the discounted value of its future cash flows, as is commonplace in the equity and real estate markets. Furthermore, art is a cash flow negative asset: unlike stocks and property, art does not pay financial dividends or generate rent to owners, but it does impose storage, handling, shipping, and insurance costs.[114] Such costs underscore both a fundamental risk of investing in the art market and its speculative nature. One can make an educated bet that the price of an artwork may rise in the future, but calculating such gains is hardly a perfect science and the costs involved in taking a position in this market can prove detrimental.

It is also important to account for the potential difficulty art funds may have in turning over their investments within their proposed five- to ten-year time frames. In a 2005 report, Barclays Capital observed that art may indeed be beneficial within a "diversified" portfolio, but stressed that "to be sure of making real returns over inflation, [one] need[s] to hold it for over 35 years"—or more than three times the duration of most current funds.[115] Mei and Moses elaborate: "Art may be appropriate for long-term investment *only* so that the transaction costs can be spread over many years."[116] Furthermore, while the costs to transacting in other capital markets are homogenous and relatively low—especially with the advent of e-trading—those in the art market are comparatively exorbitant: buyers' premiums have increased steadily at auction since the early 1990s and can account for upwards of 10–20 percent per transaction (versus an approximate range of 1 percent, or less, with stocks) (table 1 shows the escalation of these fees at auction).[117] This further amplifies the investment risks enumerated above.

Because such transaction costs are neither uniform nor transparent, they are omitted in most economic literature, meaning that the aforementioned studies of historical art investment returns are inflated.[118] It is therefore of utmost importance for funds to reduce these fees. Fernwood was certainly aware of this and noted that, "because of [their] buying power, [they] are able to purchase fine art at substantially lower transactions costs," similar to trading discounts given to powerful institutional investors in other financial markets. The extreme disparity in the cost of transacting at auction versus in the equity markets suggests that to *meaningfully* diminish such fees, firms must trade actively in the dealer or private markets. So doing, however, may not be easy, as discussed in the next section.

We should also acknowledge the limits to arbitrage that burden art investment returns. The aforementioned absence of a financial derivatives market for artworks and the fact that that there are no perfect substitutes for unique artworks offer obvious examples of this as they inhibit the ability of arbitrageurs such as art funds to correct market mispricings. Moreover, even when pricing inefficiencies are identified, the risks and costs attributed to investing may outweigh the benefits. Economists Bruno Frey and Reiner Eichenberger explain: "Art market speculators may correctly forecast rising demand for top paintings, but it is nearly impossible for them to foresee whether export and other restrictions arbitrarily imposed by government in response to fickle public pressure leads to a dramatic fall in price. More generally, the dependence of art prices on political and administrative interventions hinders successful arbitrage."[119]

Table 1
Buyer's Premium at Christie's and Sotheby's, 1975–2009

Date	*House*	*Buyer's Premium*
September 1975	Christie's	10% inclusive
September 1975	Sotheby's	10% inclusive
January 1993	Sotheby's	15% on the first $50,000 10% thereafter
March 1993	Christie's	15% on the first $50,000 10% thereafter
February 2000	Christie's	17.5% on the first $75,000 10% thereafter
March 2000	Christie's	17.5% on the first $80,000 10% thereafter
March 2000	Sotheby's	20% on the first $15,000 15% between $15,00 and $100,000 10% thereafter
April 2002	Christie's	19.5% on the first $100,000 10% thereafter
April 2002	Sotheby's	19.5% on the first $100,000 10% thereafter
January 2003	Sotheby's	20% on the first $100,000 12% thereafter
March 2003	Christie's	19.5% on the first $100,000 12% thereafter
January 2005	Christie's	20% on the first $100,000 12% thereafter
January 2005	Sotheby's	20% on the first $200,000 12% thereafter
January 2007	Sotheby's	12% on the first $500,000 20% thereafter
February 2007	Christie's	12% on the first $500,000 20% thereafter
September 2007	Christie's	25% on the first $20,000 20% between $20,000 and $500,000 12% thereafter

Table 1 *cont.*

Date	*House*	*Buyer's Premium*
September 2007	Sotheby's	25% on the first $20,000 20% between $20,000 and $500,000 12% thereafter
June 2008	Christie's	25% on the first $50,000 20% between $50,000 and $1,000,000 12% thereafter
June 2008	Sotheby's	25% on the first $50,000 20% between $50,000 and $1,000,000 12% thereafter

Source: Christie's, Sotheby's Press.

Note: Prior to 1975, the major auctioneers only charged commissions to sellers (ranging from approximately 12 percent to 30 percent). With the introduction of the buyer's premium in 1975, originally only applied by Christie's and Sotheby's to sales in Europe, the seller's commission was reduced to approximately 2 percent to 10 percent. The buyer's premium was introduced in the United States when Christie's opened its first auction house in New York in May 1977; Sotheby's (then Sotheby Parke Bernet) began charging the premium in New York in January 1979.

The field of behavioral finance raises similar challenges to the applicability of the Efficient Markets Hypothesis (EMH), a central feature of Portfolio Theory.[120] EMH is based upon three assumptions: (1) investors are rational and value securities rationally; (2) to the extent that investors are irrational, their trades are random and cancel each other out; and (3) to the extent that investors are irrational in similar ways, their actions are met by rational arbitrageurs who eliminate their influence on prices. In contradistinction to this, behavioral finance argues that investors' irrationality and logistical impediments within the actual structure of financial markets have more profound impacts on prices than otherwise assumed.

This line of thought has come into vogue in the wake of the global economic crisis (which has revealed the frailty of assumptions about the workings of modern finance), and the art economy offers some instructive extensions of it. When applied to the art trade, for example, behavioral finance suggests that opportunistic trading strategies may be curtailed in practice because investors cannot sell short overvalued artworks or execute risk-free hedged bets. In addition, the whims of fashion and taste may undermine even the best art investment forecasts as, unlike under EMH, art market actors may not deviate from rationality randomly, but

in the same herdlike way: pricing anomalies may therefore last longer and be more extreme than otherwise supposed.[121]

Social Barriers

Art investment funds, of course, view these inefficiencies optimistically. Leveraging their quantitative and qualitative expertise, alongside their sizable purchasing power, they argue that such conditions bear rich speculative opportunities.[122] Today's art investment pioneers, like their hedge fund counterparts, are thus staking their claims on the prospects of the efficient/inefficient rift.

But current art funds are not the first to highlight the economic benefits of this market's inefficiency. In 1991 economist Richard Coffman argued that this attribute of the art economy, which stems from pervasive asymmetric information, implied that "investors have a reasonable chance of making above normal returns."[123] Asymmetric information may benefit the seller who knows more about the good than the buyer (i.e., provenance or condition) and thus knowingly withholds such information when transacting, or it privileges the informed buyer who makes undervalued acquisitions and resells at a premium.[124]

This latter scenario is precisely that championed by art funds. "Everyone who has tried this before has either been too financially focused, and didn't understand the art," reckons Taub, "or too art focused—without understanding the financials."[125] The delicate balance reconciled across analytical investment metrics, art-historical knowledge, and "insider" savvy is strategically intended to help these funds profit from such informational deficiencies. Nevertheless, bargains may be limited at auction due to exorbitant fees, a point Coffman emphasizes.[126] To truly reap the financial rewards of asymmetric information and market inefficiency, art investors must transact outside the auction sector and in the private markets instead.

Olav Velthuis's research on the contemporary art economy suggests that this objective will be challenging for funds to achieve. Drawing on empirical data—interviews with contemporary art dealers in Amsterdam and New York—and the field of economic sociology, he argues that free-market transacting is restricted in the art economy due to deeply embedded cultural conventions.[127] The foundations of Velthuis's argument are not unique—revisionist accounts of other financial markets have been similarly articulated—nor does he discuss art funds. But his approach to the art economy is fresh and yields some important ways of reconciling our analysis of art investing (itself exemplary of free-trade ideology) as

well as our broader enquiry into the relationship between art and global finance.[128]

The single most penetrating concept he deploys is what sociologist Viviana Zelizer calls "circuits of commerce." Velthuis elaborates:

> Rather than being solely motivated by utility maximization, members of . . . circuits may be inspired by concerns of status, care, love, pride or power. In daily economic life, they not only need to collect information and make decisions on its basis, they also need to make sense of the behavior of the partners they engage in trade relationships with. This behavior may not be universally rational, but it does make sense within the circuits that economic actors inhabit.[129]

The applicability of this statement to the art market is considerable. In a system where artist-dealer-collector relations are highly personal, even familial, economic decisions are actively restrained by social dynamics.[130] Because of this, the *art world circuit* (where profit is but one factor in a more elaborate cultural system: economic plus cultural capital) can be seen to distinguish itself from art funds' *financial circuit* (where profit rules: economic capital alone). Hostility between the two can be understood as a battle over conflicting "utility maximizing" objectives.

The presence of multiple, and potentially conflicting, socioeconomic circuits greatly expands our understanding of art investing as a merely abstract financial exercise: the will to sustain long-term artist-collector relationships on behalf of dealers (of one circuit) implies that purely speculative parties (of another) may be barred from otherwise lucrative trading opportunities. To illustrate this, Velthuis discusses the inefficacy of art investors to capitalise on auction/dealer pricing discrepancies. In December 1999 an exhibition of Andreas Gursky's photographs in a commercial New York gallery sold out for prices of $50,000 per item. Only two weeks before, an earlier photograph of his (*Prada I*, 1995) was hammered down at Christie's New York for $173,000, well above its $40,000—$60,000 presale estimate and despite the fact that it was of the same edition size and dimensions of the later works.[131] Velthuis observes that Gursky is one of many coveted artists whose auction prices may exceed those commanded at galleries, implying that art market price dispersion is systematic —possibly even strategic.[132]

For speculators, these irregularities indicate hypothetical arbitrage opportunities: one could theoretically buy low from a gallery and sell high at auction. But the feasibility of executing such trades is restricted because gallerists and auctioneers do not adhere to the same maxims when selling artworks. The latter seek to achieve the highest price that the market will bear at any given point in time, while the former strive to establish a fair

price that they can sustain (with steady increases) in the long run. Or, to borrow more formal economic terminology, dealers "do not let prices clear the market by selling works to the highest bidder."[133] Instead, they rely on what Velthuis calls "alternative rationing mechanisms" to enhance their ability to set the market price and to control the direction, and pace, of supply: "In their attempt to limit the possibility of future resale and investment potential of an artwork, dealers restrict rather than enhance the liquidity of artworks: they construct moral and even semi-legal boundaries between the auction and avant-garde circuit to prevent arbitrage from taking place."[134]

These preventative measures are hardly altruistic and it can be largely out of self-interest that dealers attempt to safeguard their artists from speculative forces—which, in the case of a sudden flooding of works to market, may unduly signal an artist's weakness and deteriorate his or her prices.[135] One way of achieving this is by "placing" works with trusted collectors and stipulating a first right of refusal should the collector wish to resell the artwork. Although many gentleman's agreements are verbal, some are specifically written into sales contracts. Whatever the case, they are certainly effective at limiting speculation: "collectors do not engage in arbitrage since they know that it will harm their future relationship with a dealer." Velthuis highlights a scathing remark from one of his dealer interviewees: "If there is a Luc Tuymans on the secondary market, that is here, not at the auction houses. Because the collector does the right thing, he gives it to us, so that we feel good about him buying other works, even by this artist. If he would put it at auction, we would never sell to him again, we punish him."[136] Indeed, collector blacklists circulate within the dealer community.[137]

This antispeculative vehemence is sound business sense. In fact, dealers' suppression of the economic—that they will not adjust to "parasitic" auction prices for a quick profit—may ultimately strengthen their financial prospects: collectors continue to do business with them because they trust their prices, and so the quality of their inventory.[138] Dealers' aversion to the auction circuit is linked not only to its perceived price volatility but also to their distaste for its short-term priorities: whereas dealers are indebted to sustaining an artist's entire career, auction houses principally seek rapid and profitable turnover. The downside of this is not merely sentimental: as goods leave the dealers' inventory and extend beyond the network of collectors who comply with the first right of refusal, their control over supply diminishes—and with it, their monopolistic price control mechanism. (No wonder they commonly repurchase their own artists' work at auction, which enables them to set a public market price and to enhance their control over supply.)

When analyzing the art trade's financial dimensions, we should also acknowledge the diverse manifestations, and equally diverse *meanings*, of gift-giving and moral obligation. Velthuis states: "My findings suggest that the structure of the art market is supported by more than just the monetary influx of collectors buying art for hedonistic purposes. Instead, the market relies on a dense fabric of mutual gifts and favors: dealers subsidize artists, artists donate works to dealers, collectors occasionally buy works to support an artist or a gallery, or enact the role of the dealer's moral and financial banker."[139] Or, as Zelizer elsewhere argues, "gifting" may be as "pragmatic, calculating, and obligatory as market transfers."[140] The true price of collecting thus appears to be more complex than neoclassical economic analysis indicates: social obligations must additionally be accounted for when projecting hypothetical art returns.

We should, of course, be careful not to overstate the case. The high levels of speculation evident in the contemporary sector during the latest boom, especially the unprecedented volume of contemporary art being sold at auction, suggest that the preventative boundaries and social obligations highlighted by Velthuis also have their limits. If a collector's bid is high enough, in practice we find that many dealers will ignore these codes and sell an artist's work nevertheless. Yet despite obvious, and even widespread, exceptions to the rule, preexisting social ties and loyalty are clearly elemental to the dealer market's vitality and suggest that, unlike the implicit liberal ideology of economic theory, "the art market is far from a democratic institution."[141] And this implies that art funds' investment objectives may be intrinsically flawed: because their vindication of art as an asset class is based so strongly upon free-trade economic theory, they may have underestimated the behavioral aversion of the market—especially the dealers-cum-buyers who are integral to their success—toward such unabated speculation. Their success, then, clearly resides in their ability to get the market to play by their rules.

• • •

This line of thought helps explain why art dealers are commonly regarded as the best art investors. The caveat here is that their "investments" are composed of both symbolic *and* economic capital, as theorized by Bourdieu: dealers are ultimately *socioeconomic maximizers*, cultivating the value of their capital stock and their own symbolic reputations—the two interpenetrate one another—for long-term gain.

One upshot is that an implied premium may be charged in the dealer market should art funds wish to transact independent of the field's prevailing social conventions. This could be reconciled as the premium to

trade speculatively. In practice, it implies that art funds may have to offer their dealer-buyers more generous financial arrangements than these dealers' preferred clients in order to receive the best works. Dealers could thus potentially "punish" art funds by making the *real* costs of doing business with them exceed the theorized gains. In other words, art funds might become victims of their own success. The costs associated with transforming the art market's embedded relationships into fluid, high turnover business ties may nullify the respective trading profits realized in so doing.

An additional hindrance for art investors is that failure to be inscribed within the dealer hierarchy means that their potential trading universe may be preemptively restricted. If this occurs, art funds may be forced to trade in goods with sizable secondary markets and may be ostracized from other potentially lucrative avenues. For example, even if dealers and gallerists are willing to trade with art funds in the secondary market, they may hesitate to do so in the primary market where they have the most incentives to protect their artists' career paths. It is, of course, in the interest of funds to promote and advance the careers of the artists whose work they hold by loaning to exhibitions and marketing their work—key to their value-added active management strategy. Yet because they have a fiduciary duty to investors to sell at the maximum price, rather than to place work with trusted collectors and institutions, they may inevitably aggravate these same dealers and gallerists when they "dump" work back onto the market. This means that art funds may have only limited access to the market sector where investment rewards, and risks, are arguably the greatest.

It is important to note, in this respect, that most art funds—unlike hedge funds and private equity funds—do not have exclusive relationships with their traders. Instead, they tend to buy and sell through dealers who are also active in the market independent of the fund. They then attempt to align the interests of these hired hands by offering them financial incentives to place work with the fund. FAF, for instance, offers its art buyers an undisclosed annual consultancy fee, a finders' fee ranging from 2 to 10 percent and a portion of the carried interest at the end of the fund's life.[142] However, while there are advantages in maintaining non-exclusive trading relationships (dealers who are already active in the market may have the best access to quality work and the deepest client networks, not to mention that certain parties may not wish to knowingly trade with an art fund), it is unclear whether or not such incentives will ensure them of prioritizing funds over other avenues.[143]

Three factors bode in favor of the dealer/"art buyer" remaining faithful to the fund. One is that the dealer believes that the above incentives are more lucrative than short-term independent trading upside; a second is that the dealer does not want to bear the transaction risk alone; and a

third is that the dealer does not have the capital to trade without the fund's financial backing. Unless the dealer's consultancy fee is significantly large, or unless the dealer stands to sufficiently profit from the fund's overall performance, the first point is dubious. Suppose that a dealer who acts as a buyer for a fund identifies a work for sale at $100,000 that she knows she can resell to one of his clients for $200,000. In this case, it is difficult to believe that the dealer would give this work to the fund. If traded independently, she could net $100,000, which even after steep transaction, administrative, insurance, storage, and shipping costs of 15 percent would still earn him about $85,000. On the other hand, if the work were sold through the fund and the dealer received a precost 10 percent commission, she would only, at best, receive $10,000 plus a percentage of carried interest associated with this work at the end of the fund's life. In reality, a dealer would only presumably choose not to execute such a transaction alone if the fund's fees and incentive structures were large enough (an unlikely event), or if she was not actually certain about his ability to resell this work at twice cost.

This accounts for the second point above and reiterates why art funds are risky enterprises: one expects that rational dealers-cum-buyers would save the best opportunities for themselves and allocate only weaker and riskier assets to the fund. We have seen this before in BRPF's advisory relationship with Sotheby's, which was reported to have passed along low investment grade assets to the fund. A main factor preventing this conflict of interest nowadays is that dealers tend to purchase work at a deep discount that they can turnover rapidly, whereas funds' longer-term buy-and-hold strategy enables them to acquire inventory with less obvious immediate returns. To the extent that this is so, the type of work dealers buy for themselves and source to the fund need not be the same. Yet because art funds need to generate returns in order to raise capital during the early stages of their development (especially as they seek to tap the instiutional market where investable assets and compliance hurdles are at their greatest), in actuality they may be competing for the same deeply discounted work as their dealers/buyers. This is a severe conflict of interest that is yet to be overcome by the present generation of art funds.

The last point is certainly the one that funds emphasize the most. This coincides with Taub's aforementioned desire to bring capital and liquidity to the art marketplace and explains why Hoffman is adamant that art funds are strategically positioned better than dealers: in theory, art funds should have access to more money, quicker and with less strings attached than their competitors. Certainly the biggest current issue in relation to this point is art funds' ability to actually raise sufficient capital and put their superior purchasing power to work; we will look at this more thoroughly in the next, concluding section. But irrespective of this, the lack of

investable assets in the dealer community does not preclude dealers/buyers from either receiving bank loans to finance such transactions or partnering with another party to execute these deals. Funds do have speed and low administrative hurdles in their favor: the majority of financial services institutions do not lend against art, while a credit advance may be time-consuming and costly even at institutions that do (there are also likely to be upward limitations on how much banks are willing to loan against collateralized art); and it may be laborious for a dealer to find another nonfund party to partner with. In the end, however, conflicts of interest prevail and it is unclear whether incentive structures and rapid access to capital would ever consummate an entirely efficient financial relationship between practicing dealers and art funds.[144]

Art Funds Today

Less than a year after ABN-AMRO launched its art investment advisory service in 2004 and attempted to inaugurate a fund of funds, it deserted both enterprises. Company spokeswoman Carolein Pors claimed that "the available art funds were not sufficient to put together a fund of funds." Meanwhile, of the twenty art funds on which ABN-AMRO performed due diligence, they offered their clients only *two* (FAF and the China Fund) as third-party investment vehicles: "While a host of funds are currently jostling to find investors," it was reported in 2005, "few are succeeding. Most have scaled back their initial optimistic targets and only one [FAF] is actually up and running." One unnamed insider postulated that ABN-AMRO's defection "screwed the market [for art funds]."[145]

The opposite fates of FAF and Fernwood offer an indication of how the industry is unfolding. In its first year of operation, FAF I returned an average of 54 percent on sales, and through October 2009 it had achieved average annualized returns of 34 percent on assets sold since inception. Three additional funds are also in operation—the Fine Art Fund II, the China Fund, and the Middle East Fine Art Fund—with two further vehicles on the horizon: The Fine Art Fund III, a five-year, closed-end fund that will focus on acquiring art at distressed prices; and the Indian Fine Art Fund. In aggregate, FAF has generated returns of 30 percent on all of its realized assets to date.[146]

Fernwood, on the other hand, closed without notice in June 2006, only weeks before it was to have closed on what was reported to be an initial tranche of $25 million.[147] The firm's management never gave an exhaustive public explanation for this closure, but Michael Plummer, then chief financial officer, has offered thus: "We were concerned whether Taub had the financial stability and the wherewithal to manage the funds during their life.... I studied the macro-economics of the art world for ten years. Art fairs have made changes and so have databases. But things are still run by a small group of insiders. And there is a lack of capital because of that."[148]

The reality appears to be far more dire. In February 2007 a consortium of investors who had purchased preferred shares in the parent company of Fernwood launched a lawsuit against Taub on grounds of embezzlement, fraud/intentional misrepresentation, negligent misrepresentation, and breach of fiduciary duty, among other claims. It claims that Fernwood

> was in fact little more than a vehicle for Taub to propel himself into the rarefied social circles of the art world by using other people's money. Taub's intention, borne out by his conduct, was to use his wife's and his social connections to gain access to wealthy individuals connected with the art world, obtain their funds through a sale of stock in Fernwood, insure that no one but he had control over the funds or access to information about their use and then use the funds to finance his own social aspirations and lifestyle.[149]

Furthermore, the $8 million alleged in the suit to have been raised by Taub was less than one-third of what had otherwise been reported and came nowhere near to the $150 million the fund initially sought.[150] Nor was this money even for the proposed funds, but simply to capitalize the parent company: Fernwood never actually raised any capital for its core investment activity. As arguably the single most high-profile art fund alongside FAF in the recent period, Fernwood's failure has gravely damaged the prospects of this industry as news of its collapse has ricocheted throughout the worlds of art and finance. This would only become worse were Taub to be found liable, his fall from grace underscoring the severe risks of investing in an industry with limited oversight and regulation, and almost endless smoke and mirrors.[151]

• • •

After the initial scramble for funding and innovation passes, the art investment universe may undergo a series of revisions—if it survives at all. One avenue is that of progressive specialization, or what Fine Art Wealth Management calls a "sector allocation" trend.[152] Here we see funds shifting from diversified art investment strategies, as embodied in Fernwood's proposed Sector Allocation Fund and FAF's two flagship diversified funds (FAF I and FAF II), to more focused sector-specific strategies limited to work of certain media or from particular geographic regions. The 2007 launch of WMG Photography Collection, a £10 million fund

based in London that sought to invest in several thousand photographic prints, followed in 2008 by the opening of the Merit Art Photography Fund, based in Vienna, are indicative of the former tendency, yet the latter is most prevalent.[153] This is reflected in FAF's Chinese and Middle Eastern investment vehicles, The China Fund and Aurora Fine Art Investments, which reportedly invested in circa $100 million of Russian art since its founding in 2005. New York-based Meridian Art Partners, set up by Andrew Littlejohn and Pamela Johnson in 2008, which sought to raise CHF 100 million for art investments from across the emerging markets spectrum, offers a further example.[154]

There is also a growing level of art fund activity in developing regions such as India. Some of the most noteworthy recent initiatives include the Osian's Art Fund, launched in 2006 by entrepreneur Neville Tuli as a further venture of the Osian's art conglomerate (which also owns the eponymous Indian auction house, as well as art advisory, film and publishing businesses); the Yatra Fund, launched in 2005 in partnership between Edelweiss Capital, a financial services company based in Mumbai, and Sakshi Art Gallery, Mumbai; and Crayon Capital Art Fund, launched in 2006 by asset management company Crayon Capital and Vadehra Art Gallery, both based in New Delhi.[155] These ventures are especially interesting because they signal the escalating relevance of the developing markets within the global art economy and reveal some key differences between art investing in these areas and in the West. The close strategic ties between these funds and leading Indian galleries and auctioneers is unheralded in the European and American context where, as we have seen, these parties have tended to erect far more rigid barriers between themselves and art funds. That this is less the case in India, or in other regions such as the Middle East and China, is telling and will be of utmost importance to the progression of the art market onto a truly global stage.

A second significant tendency is the shift toward opportunistic investing strategies. This has been prevalent from the outset, both in Fernwood's proposed Opportunity Fund and as one of the strategies deployed across FAF's various investment vehicles. However, due to significant price volatility within certain sectors of the market in recent years (especially for contemporary art), as well as the difficulty of actively managing a large, diversified portfolio of art investments (a hindrance also encountered by BRPF), a number of funds shifted more explicitly into this space beginning in 2008. In January 2009 FAF announced its intention to raise between $50 to $100 million for a new fund (FAF III) that would focus on distressed artworks whose prices have plummeted in the face of the economic crisis.[156] And a similar strategy also featured prominently with two funds founded the previous year: London-based Dean Art Investments, which sought $50 million and was to be advised by Jeremy Eckstein, formerly of Sotheby's and an advisor to BRPF; and ArtPlus, which sought up to $200 million and was to operated out of Luxembourg and Israel by brothers Serge and Micky Tiroche, the former an ex-Citigroup banker, the latter a cofounder of the Tiroche Auction House in Israel and director of a London gallery.[157]

Art investment syndicates run by market insiders seeking to escape administrative and regulatory constraints may also come to occupy a significant role. Investment banker-turned-dealer Robert Mnuchin, director of L&M Arts, New York, inaugurated such an initiative in 1993 and continues to run it as a small limited-partners fund with capital from ten principal investors (although details of its size, strategy, and returns have never been made public).[158] And Daniella Luxembourg's ArtVest has similarly discreet objectives (the majority of investors are long-time clients and friends). One witnesses it outside of the fine art trade as well: in 2005 New York map dealer Graham Arader solicited $200 million for the establishment of his own fund (though he ultimately abandoned the effort the following year).[159] Such ventures must be distinguished from funds that attempt to provide a structured investment solution for qualified HNW and institutional investors, but they are a notable presence in the market and are attractive precisely because they eradicate some of the major logistical hurdles and conflicts of interest that belabor vehicles like FAF. "Collectors/art investors are putting together small syndicates and they increase in number daily," explains New York art advisor Thea Westreich. "You see them at fairs; they're wearing baseball caps and sneakers; they act covertly but dealers are starting to recognise them.... All these new financial ventures will ultimately skew the marketplace."[160]

Precisely how they may do so remains unclear, but perhaps it is ultimately a matter of art funds converging on the business models of other art financial services firms. To the extent that they can be expected to continue, art investing as a formal practice may disintegrate into a more indistinct collection management and financing business. This would further reinforce comparisons with hedge funds, which at their peak were also in the process of shifting away from their key competencies toward more prominent undertakings in the insurance, private equity, and banking sectors—"making them rapidly becoming indistinguishable from the rest of the financial-services industry."[161]

In the art fund sector it is nevertheless unclear just by how much demand for such comprehensive services will increase even as HNW and institutional investors without extensive art market expertise—or the resources needed to independently manage their collections—enter the art trade. Unresolved as well is *who* will ultimately be best at supplying these provisions. On one hand, if demand for these services accelerates, auctioneers, banks, and dealers will presumably mount a stern challenge to

art funds; on the other, it may prove too laborious and costly for art funds to simultaneously meet their investment objectives and provide these faculties. Or these vehicles may be phased out altogether: "I think what we may be seeing is not less interest in diversifying one's portfolio to include art," Moses surmised in 2007, "but, rather, that individuals who decide to invest in art want to do it on their own. They don't need a manager for their art investments, and that causes an art fund to have a lot of headwinds to sail into."[162]

Despite even FAF's track record, it, too, bears this out. Most significantly, Hoffman and his team have raised less than $100 million across all of their funds, versus a projected target of $350 million at inception in 2003. Furthermore, the strong investment returns reported by FAF only tell part of the story. To begin, it is hardly surprising that the returns posted by FAF in its early stages have been impressive, as any such figures would tend to capture the performance of assets that had proved to be particularly "good" investments (with the drag of poor investments only being felt toward the end of a fund's life once all of its assets had been sold off). Second, because FAF is not under any legal obligation to disclose details of its investments (it is an unregulated business), there may be selection biases in the type of information it shares with the public, therefore lending an artificially rosy outlook to its prospects. Note, for example, that while the fund discloses its returns on assets already sold, it does not share the marked-to-market valuation of its overall investment portfolio, which may be weaker. Lastly, and related to both of these points, most of the assets it has sold up to 2009 benefited from an extremely prosperous period in the art market (not unlike BRPF's Impressionist sales of the late 1980s). However, it is not yet clear what effect the art market crash beginning in autumn 2008 will have on its overall investment portfolio. The fund has stressed that the majority of its assets are still valued above cost and that it has only sold one artwork at a loss (of $40,000), but its future prospects are far from certain—especially if the market's recovery is slow to take shape.[163] One need only recall that it took upwards of seventeen years for price levels to regain parity with their peak of the 1980s bubble (graph 1), a situation that, if replicated, could hold an ominous fate for funds like FAF with ten-year terms.

The broader art fund landscape reflects this more sober picture.[164] Due to fund-raising difficulties and other, more basic problems incurred in the setting up of such businesses and the marketing of them to investors, many of the funds discussed in this chapter have been put on hold or dissolved outright. The list of casualties, which has been steadily mounting in the wake of the market downturn, is extensive and includes the China Fund, the Osian's Art Fund, the Art Trading Fund, Meridian Art Partners, Dean Art Investments, ArtPlus, a variety of funds proposed by Société

Générale Asset Management, and the Art Dealers Fund, by MutualArt, among many others.[165] Littlejohn, of Meridian, gives his perspective:

> Right now, the major problem with art funds is liquidity and transparency. People are not willing to lock up their precious capital in this economic environment, and especially if they do not fully understand how the investment operation works—on all levels. We have endeavoured to respond to the latter with a fully transparent, institutional grade structure, that allows investors to know exactly how we operate and what is in the portfolio. We have a full custodial and administration structure so we have no access to investor money directly and all reporting comes from an auditor. But the main issue is client demand. There really is just not enough of it right now, and likely will not be for at least the next two quarters and maybe more. Then, there will be a sea change, and people will flock to invest in real asset vehicles.[166]

In January 2009 Sergey Skaterschikov, chairman of Skate's Art Industry Research & Ratings, was forced to delay the publication of an in-depth review of art funds "due to the failure of such funds to become a major force within the art market.... Most of these funds are struggling to raise capital."[167] Skaterschikov reckoned that upwards of fifty art funds have been announced, with just $250 million of capital between them—or only approximately $150 million spread across the field, excluding FAF. This is an extremely small pool of money by financial industry standards, and it helps to temper the considerable media spotlight that has been shined on this field in recent years. Indeed, by 2010 FAWM revealed that it tracks only twenty funds, down from fifty at its peak.[168] Art investing may yet mature into a vital part of the global art economy, but it has a number of major hurdles still to clear as funds first need to convince the marketplace of their relevance and then raise enough money to vindicate their worthiness in practice.

There are other unresolved questions as well. Can funds capture the risk-return profiles of art investing alluded to in theoretical market research? Will funds be able to resolve the conflicts of interest with dealers that they employ as advisors and buyers? And even if so, will they do this efficiently enough, and in absence of onerous fees, that they are able to generate the high turnover and aggressive investment margins they seek? FAF offers at least some hope that this may be possible; but Fernwood's failures, the weak historical track record of these funds, and the scaled-down aspirations and fundraising troubles of most vehicles in operation at the beginning of the new decade allude to the bleaker implications of such risks.

• • •

I conclude by taking three additional, and arguably even more fundamental, issues onboard. The first extends from the preceding chapters and concerns what affects the shift to a more diffuse economy of artistic goods, services, and experiences may have on the practice of art investing. Might this handicap funds' reductive assumptions about the values of art? In truth, the developments charted in the earlier case studies are unlikely to have any great impact on funds' objectives and operations: they remain overwhelmingly focused on the paintings trade, and this will almost certainly continue to be the case until practices like video and experiential art establish a more robust commercial footing, especially in the secondary market. Contemporary art in its broader sense nevertheless remains a prominent focus of many funds established to date (comprising upwards of a third or more of many "diversified" funds' portfolios), and the sector's dramatically elevated footing in the international art market over the past decade suggests that it will be firmly on the radar of funds in the future irrespective of whether or not they are invested in it (its successes and failures playing an ever more important role in determining the health of the global trade). This is a significant point and means that the contemporary sector cannot be ignored over the longer-term, even if it is but one component of most funds' investment strategies. Of more immediate concern is that a shift by dealers toward more protectionist agendas in the face of the market downturn, characterized by strategic underpricing and increased emphasis on carefully placing and sustaining an artist's body of work, could be detrimental to funds currently in operation by taking liquidity out of the market.

The second issue, concerning the veracity of the supposed noncorrelation between the art and the financial markets, has also been thrown into the spotlight since the contemporary art bubble burst in autumn 2008. This sudden reversal, irrespective of whatever benefits art may have in a broad financial portfolio, demonstrated that the worlds of finance and art are closely linked, and in particular that major shifts in global wealth levels can have a profound impact on art prices. It also led to an immediate softening of investor demand for art funds and the sudden drying of liquidity in the art market as a result of the crash raised questions about the efficacy of their trading strategies. FAF's Hoffman has gone on record saying that the fund stopped buying altogether during the first half of 2009—"to let the dust settle"—but most other funds that were still in the capital-raising stage at this point did not have this luxury.[169] Many art funds were abandoned as a result, and it is unclear what impact this will ultimately have on this landscape in the coming years.

At an even greater level of abstraction, one final issue concerns whether the very nature of art investing may erode art's symbolic value as the ultimate mark of *distinction*, as conceptualized by Bourdieu. As art becomes

an ever more ubiquitous consumer good, its utility as a store of intrinsic economic value—a function predicated upon claims to prestige, exclusivity, and singularity—may subsequently deteriorate. Will art funds' explicit investment objectives—the reduction of art to finance—eventually lessen the symbolic, and ultimately economic, allure of acquiring art? Only time will tell. But should the art fund vision go on to flourish, we cannot ignore the possible ramifications that this could have on the trade as a whole: the reduction of art to a democratic and purely financial asset, serving to undermine the symbolic economy that has supported so much of the market's extraordinary prices in the first instance.

The instrumentalization of art—as an *asset class*, as an *investment*—is a work-in-progress. Yet we should remember that it is an experiment with historical precedent. In deliberating this frontier, we must therefore begin to focus less on the acclaimed singularity of these funds' business models and more on their ability to permeate within the actual culture of the art market and to achieve real returns in practice. These factors will prove critical in determining the fate of the art fund model, and the greater our awareness is of them, the more we will begin to appreciate the synergy between them and other contemporaneous developments in the art economy. And the better prepared we will be to evaluate their successes, failures, and implications, as well as their rightful place in the art market's ever evolving course.