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The price of exotic genius

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Hugh Grant, the actor, pocketed a profit of more than £9m ($17.9m) when he sold a silkscreen print of Elizabeth Taylor by Andy Warhol in November, just six years after he bought it for about £2m. It is the kind of return that would make even the most successful hedge fund manager envious.

Newspapers are full of such tales. Newly made millionaires in newly rich economies such as China and Russia are scrambling to secure cultural assets. Christie's, the auction house, reported record sales of Asian art to buyers from China and India last year. Sotheby's, its rival, claimed 2007 was its best-ever year for Russian art sales. But it is striking that in spite of reports of record price rises, investment banks such as JPMorgan do not designate art as an investment class.

Janine Racanelli, head of JPMorgan Private Bank's Advice Lab, says that if wealthy clients have a passion for art and "it is an important part of their balance sheets, then we have to look at the implications". For example, there may be tax and inheritance issues. The problem, she adds, is that there is not enough accurate data on returns and no established price index against which to measure investment returns.

Most bankers worry that the art market is opaque, illiquid and unpredictable. "We don't have an appropriate way of judging, monitoring or assessing the risk/return profile," says one adviser. Clients cannot trade a painting as they would shares, he says. There are no marketmakers dealing daily and displaying publicly what price they will pay for a Rembrandt.

Getting a good price for most artworks depends on the state of the market, lurches in fashion and luck. Moreover, there are hidden costs associated with buying and selling art. These range from the price to employ auctioneers and an expert who can spot fakes, to the cost of transporting a work home.

And then once on the wall, a painting is cashflow negative – it does not pay dividends and usually costs a lot to preserve and insure. Ms Racanelli says that increasingly clients take out "title insurance" to protect them if it turns out that their prized possession is fake, stolen or has been expropriated.

Even so, a number of hedge fund and investment managers have set up art funds to cash in on rising prices. In July, the Art Trading Fund, which uses derivatives to hedge against a fall in the market, was launched. Shortly afterwards, Société Générale Asset Management launched a Luxembourg-based fund to invest in modern art using private equity techniques.

SGAM argues that the art market is becoming "more and more professional". The rationale is that art prices, like other exotic alternatives to mainstream equities, move in opposite directions to shares or bonds. When stock markets fall, art prices are supposed to remain steady or even rise. And if they are part of a wider portfolio, they will diversify risk.

However, some research by academics and investment professionals suggests that art prices are strongly linked to consumers' sense of economic wellbeing. That means that when economic growth turns down, prices fall.

Avoid embarrassment by establishing the provenance of artwork

As more collectors lend their art to travelling exhibitions, the chances rise that museum staff or visitors could recognise a work as one that was lost or stolen during war, **writes Pamela Ryckman**.

"Every day you read about art stolen and recovered years later – either garden-variety theft from museums in Europe or the restitution of works of art confiscated by the Nazis," says Dorit Straus, worldwide fine art manager at Chubb.

For no extra cost, the insurer provides up to $100,000 in legal defence funds for clients sued by third parties for works in their collections.

Ms Straus, an Israeli raised in Vienna, says Chubb's intent is not to penalise victims. "By working with appropriate

A study by analysts at Dresdner Bank in Frankfurt at the beginning of the decade showed that over the very long term – two lifetimes, for example – paintings by Cézanne, Picasso, van Gogh, Turner and Canaletto outperformed German bond and share markets.

But the study also showed that economic slowdowns lead to falls in demand and a rise in forced sales. And it debunked the perception that art was one of the few beneficiaries of high inflation.

This accords with the experience of the UK-based Railways Pension Fund, which invested £40m in a range of artworks and antiquities between 1974 and 1980. It did so in the hope that the value of the portfolio would keep pace with inflation, which was running at an annual rate of 30 per cent. Meanwhile, markets in financial assets – government bonds, shares and property – had collapsed.

By 1987, markets had recovered and the fund's trustees became concerned that art prices were not keeping up with inflation as efficiently as other investments. They decided to sell the portfolio and buy more appropriate mainstream inflation-linked products, such as index-linked gilts.

But the trustees found that they could not sell quickly. They sold some works at the art market's peak between 1987 and 1989. The highlight was the sale of "La Promenade" by Renoir, which was bought for £680,000 in 1976 and sold for £9.4m a decade later. But the Fund sold little between 1990 and 1994 when the UK economy and the art market slumped. It was left with pieces it did not want.

In total, between 1976 and 2000, the Fund's annualised returns from its art sales exceeded inflation by 4 per cent. The overall return was 11.3 per cent a year. But these returns were overshadowed by total returns from more liquid investments such as shares, which returned 11.5 per cent a year above inflation over the same period. Bonds paid out total returns of 6.7 per cent a year.

The trustees concluded that the downside of investing in art is this: there are no reliable methods of valuing portfolios. And administration, storage and insurance costs can be high in comparison with other investments.

attorneys, we can determine whether it's a legitimate claim, and if our client was a good-faith purchaser of a work originally seized by the Nazis."

Regardless of any potential claims, she encourages clients to perform the necessary due diligence on every purchase. In particular, they need to ascertain the history of ownership, known as "provenance".

"You need to make sure you're not buying something of tainted provenance and title. You should do it when you're planning to lend a work to a museum, rather than being embarrassed when a museum does it," she says.

"You should do it before you bequeath it to your children to ensure there's no impediment or question about the legitimacy of the inheritance."

Experts say proper research and risk management can be eclipsed by the art world's rampant glitz.

"Art is entertainment now; it's all about the show – going to the parties, the beautiful people, being seen and being on the boards," Ms Straus says.

"Risk management is mundane to most people. So I say leave the boring part to us. For us it's exciting; it's what we like and are good at."

Of course, some investors may be able to emulate Mr Grant's success, or they might be lucky and make a fortune out of a penchant for old masters. But they would be unwise to bank on it.

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