



Art Investment Funds and Financial centres: Opportunities for development

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Strategic Discussion Paper

In the context of the **Art and Finance Conference** organised by Deloitte and scheduled for 1st October 2008 in Luxembourg, this strategic discussion paper aims to describe and explain the current rise of art as a new asset class. It also aims to outline the opportunities which should arise from the emergence of the new financial service niche which will result from this phenomenon.

This initial discussion forms part of a more detailed investigation that Deloitte proposes to organise with all relevant stakeholders in Luxembourg. It aims to carry out a wide-ranging assessment of the potential opportunities that this new niche has to offer for the country's financial and cultural sectors.

Summary

The increase in wealth, resulting from global economic development, has created an unprecedented demand for art. In addition, the development of knowledge about the art market has meant that art is increasingly thought of as a new alternative asset class with interesting investment opportunities. In the financial sector, this interest for art has manifested itself through the growth of art advisory services within the wealth management sector, as well as through using the true value of works of art as a financial guarantee. Art investment funds have begun to make their appearance and are a sign of further innovation. Around fifty of them are at the inception stage in various parts of the world. Such developments make apparent the need for the growth of a specialised financial services niche to support them. It is highly likely that these services will be grouped in certain key geographical zones where the optimal conditions to facilitate their growth will exist. In this respect, and in a climate of competition between financial centres for a central position within this new service niche, it seems clear that, given the financial activity and expertise already existing in Luxembourg, these new financial services would offer an interesting opportunity for growth. From this perspective, Luxembourg and its financial centre need to address a certain number of strategic questions regarding how to find an advantageous standpoint in relation to this new opportunity. Naturally, should Luxembourg succeed in creating this global centre of expertise, an additional highly profitable activity would strengthen the country's competitive position, while also having very positive consequences for the Luxembourg arts sector.

Contemporaneity and globalisation of the art market

The present economy concentrates the majority of its growth momentum on the accelerated development of innovation within advanced societies and on the material catch-up of certain rapidly developing countries such as China, India, Russia and Brazil. In this way, on a global scale, the advanced integration of economic activities and the flow of strategic resources (financial, energy, information and natural) has paved the way for considerable growth in the wealth available to High Net Worth Individuals (HNWIs) and to Ultra High Net Worth Individuals (Ultra HNWIs).

The new climate of increased wealth, linked to other factors related to the current economic situation (such as the need for the transfer of inheritance between generations), has considerably stimulated the evolution of the art market. Currently, annual global sales in the market for works of art (paintings, sculptures, drawings) and decorative art (furniture, objets d'art, jewellery and textiles) are estimated at more than EUR 55 billion (while enjoying double-digit annual growth). These sales are spread across roughly a hundred specialised market sectors according to the recent estimates of Dr Clare McAndrew¹ quoted in the May 2008 edition of *ARTnews* magazine. In addition to the art market (in which the majority of the demand is from collectors) there is also the market for specialised collectors of rare objects (books, wine, vintage cars, stamps, precious stones and souvenirs).

¹ Dr Clare Mc Andrew founded *Arts Economics* in 2007. Dr McAndrew is a cultural economist, investment analyst and published author.

In a global economy focused on increasing the value of knowledge and innovation, part of the logic of the process is that 'status goods' will be highly valued and sought after by the elites, and even more so as these elites seek such goods to strengthen their brand image. Under these conditions, a new generation of collectors has appeared for whom art constitutes a significant part of their assets.

The era in which we currently live is strongly characterised by the globalisation of cultural activities, the convergence of sought-after social values, and the synchronicity of the developments which stem from this. In fact, this is a hyper-modern era which, through its own momentum, is driving the globalisation and universalisation of interest in art to unprecedented levels. All societies seek to reinforce their national and/or individual identities through acquiring works of art.

Financialisation of the art market

Over the past decade, economic institutions seem to have gained a better grasp of assessing the value and risks attached to 'status goods' (such as works of art). The development of the methods and practices of financing new technology and innovation, as well as the development of specialised, up-to-date services for the art market (regarding monitoring, communication and intelligent management of the data used for transactions) has greatly contributed to the transparency and recognition of the potential value of art investment.

The maturing of knowledge (online databases, indices), of financial practices, and of the demand for asset-structuring services further contributes to the development of numerous specialised financial services and structured finance vehicles for financial investment in art.

Works of art are now increasingly considered as a useful and high-performance alternative asset for diversifying investment. As many specialists rightly point out, including Dr Clare McAndrew in the conclusion of her recent paper on art investment (*The Art Economy – 2007*): financial institutions now realise that evaluation of the risks associated with art investment is quantifiable and manageable on the basis of a rigorous professional approach.

Currently, over fifty art investment funds are emerging in the wake of these changes, in addition to another group of investment funds focused on collectibles (wine, musical instruments, precious stones, etc.).

However, the particular features of the art market have a clear influence on these new investment channels and specialised investment vehicles. The inefficiencies of the art market make it one of the most difficult areas of investment to access, while offering high-class performance opportunities.

Accumulated experience as well as various efforts and failures made over the past thirty years have enabled this new phase of art market development to emerge, where investment should become increasingly attractive. During this new phase of development (the phenomenon has already been set in motion), groupings of specialised services with high professional value will appear. They will play a supporting role in managing investment in art and other categories of 'status goods' which operate according to the same logic of increasing the value of the investment.

Art investment funds

For a long time now, the everyday expression 'invest in art' has implied the commercial acquisition of works of art. Economic studies of the art market and of the creative industry sector have until now focused on assessing the distinct characteristics of these market sectors. These studies have also focused on analysing profitability and the correlation of this profitability with other asset classes offered by this type of acquisition.

Among the distinctive characteristics particular to the art market, economists working in the art market and creative industry sector have identified the following: uncertainty of demand, changing artistic trends, infinite variety and durability of products, asymmetry of information, opaque transactions, renowned capital, poor liquidity of art assets, complexity of accurate identification, transaction costs, unregulated markets and value increase.

However, within banking institutions, the supply of art consultancy services whose aim is to manage and build up collections has increased, as has the supply of financial credit services associated with art whose aim is to transform art into a working asset. Parallel to this, in recent years more and more actors with proven expertise in the art and finance markets are launching this type of art investment fund.

The recent financial development that the launch of art investment funds represents means that the exchange of art assets has become part of a new phase of market development by establishing, within this development, investments in the financial vehicles of mutual funds whose main objective is to increase the profitability and financial value of an asset base of works of art.

The roughly fifty existing investment funds are at the inception stage, with a few exceptions such as *The Fine Art Fund*. They are focused on recruiting investors and on developing their organisation and making them operational. Even though several of these funds have been set up in the U.S.A. (in particular in New Jersey) for tax- and client-related reasons, the phenomenon is worldwide with funds in the United Kingdom, India, Switzerland, Spain, the Netherlands, Austria, Taiwan, Hong Kong, Liechtenstein, Germany, Luxembourg, New Jersey, Gibraltar, etc.

However, these funds are already faced with the problem of finding the specialised services they require to enable them to increase profitability and especially to achieve optimal operational effectiveness and efficiency. The challenges for this new family of funds are considerable and will mean that an extensive range of specialised professional services for financial management and logistical optimisation is required.

Due to the emergence of art investment funds, wealth-management now has a new type of financial vehicle at its disposal to diversify investment opportunities and particularly to spread more effectively the risks associated with the economic situation which are inherent to the financial vehicles currently in use. In the past few years, annual global assessments of the balance of wealth, and of the wealth-management strategies in use, reveal the ever growing interest of wealthy individuals for increasing their investment in art.

From the point of view of investment fund operators and of wealth-management stakeholders, a specialised-service niche can be expected to develop, centred in certain key geographical areas so as to enable these new financial services to grow sufficiently. These specialised financial services will enable all fund operators to pass through the learning process required to rapidly achieve sustained efficiency. Moreover, it will particularly enable them to offer their respective clients a stable foundation of recognised expertise which they would otherwise not have available due to the small scale of their initial transactions.

Competition of financial centres

The considerable expansion of international trade (commercial and financial), resulting from major transformations of the global economy over the past two decades, as well as all the efforts made to harmonise international trade rules, have given a new dynamism to growth and created an expansion of the global network of international financial centres.

This development within the network of financial centres follows on from an increase of the financial services needed to accompany the new global economic growth over the past fifteen years. The upsurge in growth within the global financial system has brought about a significant increase in competition between existing international financial centres as well as the emergence of new centres within economic zones in the process of accelerated modernisation. Such is the case primarily with China, but also with newcomers such as the member economies of the Economic Cooperation Organisation of the Persian Gulf countries.

Almost all the major cities of each national economy participating on a competitive basis in the new global growth are seeking to develop and establish interventionist strategies with the aim of equipping themselves with high-performance, attractive, competitive and dynamic financial centres. Each financial centre wishes to take an increasing share of the global flow of financial activity to strengthen its economic position, and especially to benefit from the potential concomitant job creation. This is particularly true for emerging international financial centres but also applies to well-established financial centres such as New York, London, Tokyo, Frankfurt and Paris.

Furthermore, the discussions on competitiveness currently taking place within these financial centres regarding strategic choices and public policy on capacity reallocation reflect the increase in competitiveness between international financial centres.

It is clear that the financial centre of Luxembourg is highly involved in this build up of international pressure and is continually on the lookout to develop new areas of expertise. In this respect, Luxembourg has numerous advantages which relate as much to its expertise in finance, investment funds, wealth management and securitisation, as to its geographical, political, legal and fiscal, etc. environment. The flexibility, stability, and rapid-reaction capabilities of its political and regulatory system increase its attractiveness which suggests it should seriously think about and examine how to find a niche position in the particular area of art investment fund management.

Art cluster and the development of specialised financial services

Certain cities play a key role in the functioning of global economic activities. Such is the case with New York and London, but also with several other cities which group together expertise essential to some economic sectors. The conglomeration of financial activities is a well-known phenomenon.

The structure of the creative industry and art market follows the same pattern of concentration as do the determining activities for the international art market within a certain number of cities known for their 'creativity'. New York is without doubt the flagship city of the art market followed by other cities such as London, Berlin, Paris, Tokyo, Geneva, Hong Kong, Milan, Beijing and Shanghai which make up the main circuit for the majority of the world art-market trade flow. Cities such as Dubai, Los Angeles, Miami, Mumbai and Sydney are other vibrant examples.

These art clusters are supplied with the specialised services required for art-market players to perform, as well as for the roll-out of the activity and value-adding chain which form an inherent part of them: assessment of works, art and collection-management advisory, art insurance, storage and restoration, financing, auctioning, legal services, etc.

The financialisation of art markets, especially with the emergence of art investment funds, has opened up the way for creating a supply of professional financial services for these funds. The following are some of the main financial services required by this market niche:

- Fund constitution, establishment and assessment
- Consultancy for fund management and optimisation
- Asset valuation
- Securitisation of art collections
- Transaction management
- Consultancy for investors

Financial centres that seek to encourage investment funds to establish themselves and be managed within their territories must construct a business 'ecosystem' which will give them the competitive advantage and be known worldwide. By definition, art investment fund management does not need to be situated in the centre of cities most renowned for art. Funds would be better off seeking more advantageous fiscal and regulatory conditions, a pool of specialised human resources and up-to-date storage, logistics and insurance services. This would normally imply, however, that funds should be domiciled within one of the well-known global zones of art-market development, which is the case with Luxembourg.

Strategic questions to be addressed in order to proactively position Luxembourg as an attractive art financial cluster

Given the envisaged development of groupings of specialised financial services which will serve to support the wave of new art-investment instruments and vehicles (in particular investment funds), Luxembourg and its financial centre need to address a number of strategic questions.

- What is the actual competitive capacity of the main financial centres (New York, London, Paris, Geneva, Zurich, Frankfurt, Luxembourg, Milan, etc.) with respect to the strategic factors and key resources essential for developing groupings of specialised and financial services dedicated to the art market: knowledge of the art market, art banking, taxation, legal framework, valuation of art assets, market intelligence, investment fund management, maintenance and storage of collections, logistics services, foundation management, legal services, insurance.
- What is the potential position accessible to Luxembourg regarding the development of a grouping of financial and specialised services to accompany the development of the art investment fund sector?
- Which developments, strategic actions and investments are required to enable Luxembourg's financial centre to establish an attractive and competitive position in the area of specialised financial services for art investment?

Naturally, should Luxembourg, and in particular its financial sector, create this global centre of expertise, the country's competitive position would be strengthened by this additional highly profitable activity, while also having very positive consequences for the Luxembourg art cluster .

Conclusion

Based on the potential interest that this new niche of financial activities represents to the financial centre and the cultural sector, it seems appropriate that Luxembourg should adopt a proactive attitude. Mobilising the relevant stakeholders with respect to assessing the feasibility of holding a favourable position and identifying an action plan for development in the field would seem the most important course of action in the short term.

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