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IS ART SPECULATION PROFITABLE?

The enormous prices paid for paintings at auction today suggest that art is a particularly profitable field for investment. It is undoubtedly possible to reap high returns in the market for paintings—provided one has invested in the "right" pictures. The last owner of van Gogh's *Sunflowers* bought it for £24,000 in 1934 and sold it for nearly $40 million in 1986, which means a real rate of return—allowing for inflation, that is—of 11 percent per year (after deducting the auction fees). Wendell Cherry, the last owner of *Yo Picasso*, a 1901 postimpressionist self-portrait, did even better. In 1981 he bought the painting at auction for $5.83 million; he sold it at auction in 1989 for $47.85 million, achieving a real net rate of return of 19.6 percent per year. This is certainly a most satisfactory investment, but even higher profits can be had. The American real-estate investor Gerald Guterman bought a still life by Jan J. den Uyl for roughly $400,000 in 1984, and sold it for $2 million in 1988, thus reaching an annual real net rate of return of 31 percent. Even more successful was Jacob Duck's *Guardroom Interior*. Guterman acquired this painting for $21,170 in 1986, and sold it only two years later for $130,000, yielding a real rate of return (after deducting all costs) of not less than 77.4 percent per year.

But things may also turn out quite differently. It is a mistake to identify the high price rises of an auctioned painting or other antique with a high rate of return. The art market is characterized by particularly stiff transaction fees. Typically, both buyer and seller must pay 10 percent of the hammer price to the auction house (the rule at Sotheby's and Christie's in London and New York, although this is sometimes waived). In many countries these fees are even higher; they can easily amount to up to 30 percent of the auction price. There are, in addition, insurance costs, which amount to something like 0.5 percent per year of the object's value. The price of a picture must therefore rise strongly simply to cover these costs. And, obviously, as any investor in financial assets knows (but as art investors frequently forget), inflation must always be taken into account. Merely in order to keep up with the rate of inflation obtaining over the past few years (1970–88), the buyer of *Yo Picasso* must sell the painting in only five years' time (1994) for $65 million. If he wants, moreover, to cover the auction fees (assuming them to be 10 percent for buyer and seller) as well as insurance premiums, the selling price must rise to $81 million. Thus, in only five years, the monetary value of *Yo Picasso* must appreciate by not less than $33 million before the owner can be said to have made a profit.

Indeed, the price increase required to compensate for inflation plus auction and insurance fees is often not reached. Speculation in paintings sold at auction has commonly proved a mistake from the financial point of view, as a former owner of *Yo Picasso* found out. He acquired the picture for £147,000 in 1970 and sold it five years later for £283,000. But though the painting appreciated by £136,000, the investment was unprofitable. The nominal net rate of return of 8.6 percent per year was eaten up, and even surpassed, by the high annual inflation rate of 12.2 percent then prevailing in Britain. The real rate of return (after deducting costs) amounted to *minus* 3.6 percent per year. Gerald Guterman suffered a similar fate. In 1983, he bought Salomon van Ruysdael's *Nijmegen* for $780,000; he sold it in 1988 for $825,000. The gross price appreciation of 6 percent translates into a yearly real net rate of return of *minus* 6.3 percent per year.

Wendell Cherry bought *Yo Picasso* in 1981 for $5.83 million and sold it eight years later for $47.85 million. A great investment? Sort of, say the experts. But has the painting now become an $81 million clunker?

By Bruno S. Frey and Angel Serna

The possibility of making a profit in the art market is also exaggerated for another reason. Record prices are prominently featured by the media. On the other hand, what is seldom or never mentioned is the fact that many pictures are not accepted by the auction houses at all, because they are not expected to do well; nor is it usually noticed that many pieces are withdrawn during the course of auctions. At two old-master auctions on June 17 and 18 this year, 15 percent of the Sotheby's lots, and 37 percent of Christie's, were withdrawn. Such withdrawals are quite normal. The would-be sellers cannot realize their price expectations, and would suffer large losses in real terms if they insisted on selling. The visible sales and high prices therefore constitute a biased sample of the results of art auctions, and the prices highlighted by the press give an exaggerated notion of opportunities in the art market.

The frequent rejoinder to such pessimistic arguments is that one must acquire the "right" paintings. Proponents acknowledge that losses can happen, but suggest that with a feeling for and knowledge of art one can buy art that is certain to increase in value.

This argument sounds convincing, but assumes, wrongly, that only one person knows what the "right" pictures are. If one admits, however, that there must be other people who can recognize art whose value is very likely to go up, one can also assume that they will try to exploit this source of profits too, and thus the price of the relevant pictures will be pushed up. This makes it impossible to profit from the expected difference between buying and selling price, because the buying price will have been driven up by the other participants.

A comparison with the stock market makes this point obvious. Everyone knows that one can make a killing with financial speculation. Somebody who bought, for example, a share of Sony or Time Inc. on the New York Stock Exchange in June 1984, and sold it five years later in June 1989, would have reaped a real rate of return of not less than 23 percent and 26.5 percent per year respectively. For the same period, somebody who speculated in Rank or Rothmans on the London Exchange would have reaped a real rate of return of 24.9 percent and 21.9 percent respectively. (The transaction fees on the stock market are extremely small compared to those at art auctions, amounting to less than one tenth of one percent.)

So it is possible to make profits on the stock market that are as large as those the art market offers. The problem is, how to go about it? To find reasons *in retrospect* why a share or a picture has strongly appreciated in value is easy enough. To make above-average profits it is, however, necessary to find the profitable objects *beforehand*, and, moreover, to buy sooner than other potential speculators. From this point of view it turns out that the envisaged high-profit opportunities in both markets are nothing but an illusion. If the markets work well—that is, if several or even many prospective buyers are well informed—it is possible to make higher profits than elsewhere only by chance.

It may be argued—and quite rightly—that what matters in investment is not the return on individual items but rather the return on the portfolio as a whole. In the case of art, the question is thus whether *collections* are financially profitable.

Consider the case of Gerald Guterman. In the years 1981–86 he acquired a collection of forty-seven Dutch and Flemish old-master paintings; these were sold in January 1988 by Sotheby's New York at what was a major media event. But seventeen of the paintings could not be sold at the stated minimum price. More than one third of the old masters thus did not reach a price expected by Guterman; from a speculative point of view this must be considered a bad investment.

We were able to investigate the buying price for fourteen of the thirty paintings that did sell. Guterman had invested $2.7 million in these fourteen paintings; in 1988 they sold for $4.8 million (including selling fees). The real net rate of return is 3.2 percent per year. While this return is pretty good, Guterman would have done much better if he had invested in U.S. government bonds. With minimal transaction fees he could have reached a yearly real return of 6.9 percent. If he had bought industrial shares instead, the appreciation would have brought him a real return of 7.7 percent per year (to which dividends can be added). In the case of the Guterman collection, an alternative investment in purely financial assets would have been more profitable than speculating in old masters. □

Bruno S. Frey is professor of economics at the University of Zurich's Institute for Empirical Economic Research. Angel Serna is assistant professor.

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spent upwards of $50 million on his collection only to see buyers turn up their noses when he put it up for sale in 1938. It was a ghastly time for art prices. A van Dyck portrait went for only £1,995 that year in London, less than a third of what it made twenty years earlier, while, a year later, Turner's *Double Rainbow* would fetch just £110, less than a tenth of what it got in 1877. Yet the Hearst collection managed to do even worse. Auctions in New York and Chicago were flops. Although Gimbel's department store agreed to take over disposal of the Hearstian white elephant, sales still totaled just $11 million by 1941. Among the astounding discounts: a Spanish Cistercian monastery for which Hearst paid more than $1 million and then had transported to the United States *in toto*, yet which wound up going for just $50,000.

Of course, anyone who buys during a boom and sells during a bust is in trouble. But even when times are good, the story of a silver-tongued New York investment adviser named David Bloom shows that collecting is not without its perils. By the time he was just twenty-three, Bloom had sunk $10 million into American paintings, real estate, jewelry, and other accoutrements of the luxurious lifestyle he believed to be commensurate with his new role as a wealthy connoisseur. However, Bloom differed from other collectors in one significant respect: the money he used was not his own, but that of his clients, who had given it to him to invest for them in the stock market. In early 1988, he was charged with defrauding his clients of the money. At the time, the media spin on the story was that, given the stock market crash, Bloom had inadvertently served his clients better by taking their money and investing in art rather than the stocks they thought they were buying. In Bloom's case, however, he overpaid so egregiously (no small feat in a bull market) that most of his collection—including works by Sargent, Cassatt, and other American impressionists—wound up being sold for a loss.

Finally, there is the British Rail Pension Fund, proof that even if one invests carefully and soberly under optimal market conditions, art is still not much better than pretty good. Beginning in 1974, the fund's managers decided that instead of the usual practice of sinking the pension assets under their control into high-grade stocks and bonds, they would divert five or six percent—£40 million in all—into art. Sotheby's agreed to advise on what to acquire and to supervise the purchases. To spread the risk, it was decided that the money would be evenly distributed across a broad range of fields, everything from Egyptian sculpture and tribal art to old-master prints and impressionist paintings. British Rail represented the biggest corporate plunge into the art market in history, and considering that the objects were not to be put on display but would be locked away in a vault, the purest test of the art-as-investment principle to date.

By 1980, the "collections" were completed, and the world sat back to wait. Seven years later, when the fund began selling off its old-master and Japanese prints and silver, Sotheby's reported that the value of its assets had gone up about three and a half times. Amid all the crowing, though, it soon turned out that, based on the stock indexes, the money would have gone up 4.1 times had it been invested in the equity market. When dividends were taken into account, things looked even worse. Stocks pay dividends, but paintings don't (not even aesthetic dividends in the case of works hidden away in vaults). Whipping out their cal-