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Does it pay to invest in art? Returns in fine art have been overestimated

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Investors should buy paintings if they like looking at them, but not to make money, according to new research from the Luxembourg School of Finance of the University of Luxembourg, which found that returns of fine art have been significantly overestimated.

Art has emerged as a new asset class for well-diversified portfolios, with the index of fine art sales, which is used by art advisors to sell art funds, showing an average annual return of 10 per cent over the past four decades. However, Prof. Roman Kräussl (University of Luxembourg), Arthur Korteweg (Assistant Professor at Marshall School of Business, University of Southern California) and Prof. Patrick Verwijmeren (Erasmus School of Economics, Erasmus University Rotterdam) have found that returns are in fact much lower.

Their analysis of the most complete auction database available, the Blouin Art Sales Index (BASI) shows that the true annual return of art as an asset class between 1960 and 2013 was closer to just 6.3 per cent. Additionally, holding an art fund in a portfolio does not increase the chances that this portfolio will outperform. On the other hand, the risk of investing in art through a fund is much higher than estimated, according to the team of researchers. Based on the BASI, they used the so-called Sharpe Ratio as a measure to calculate risk-adjusted return. The result was 0.11, rather than the 0.27 value that has been previously reported. The greater the value of the Sharpe Ratio, the more attractive the risk-adjusted return.

According to the study, the underlying cause of the overestimation of returns and underestimation of risk is what is known as selection bias. In the art market, selection bias occurs, for example, because paintings in high demand go to auction more frequently and sell at higher prices, causing them to be biased upwards. Additionally, owners tend to sell the paintings that have increased in value the most since the time of purchase. Indices then use data from the sales of these above-average paintings to valuate the paintings that never sell of sell less frequently.

To impute a more accurate value to the latter category, the researchers used data on how often paintings are sold and how rapidly their price increases. They came to the clear conclusion about art as an investment: When comparing the investment returns and risk of all the styles of art to a portfolio of pure stocks, art investments do not substantially improve the risk/return profile of a portfolio diversified among traditional asset classes, such as stocks and bonds.

This analysis applies to art purchased via a fund. But what about buying art on a one-off basis with an eye to reselling it to make a good return? This is the equivalent of investing in a single stock or a tiny handful of them: Some people may have the skill or luck to pick winners, but others don't.

"If you own a painting, you bear the physical risks and costs, including insurance, damage, and theft or forgery, among others," commented Prof. Kräussl, concluding: "In short, buy paintings if you like looking at them. You can hope that your children will sell one or more of them later for a gain—but paintings are primarily aesthetic investments, not financial ones."

Provided by University of Luxembourg

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