

Art investment as a portfolio diversification strategy in South Africa

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Abstract

Art has been suggested as a good way to diversify investment portfolios during times of financial uncertainty. The argument is that art exhibits different risk and return characteristics to conventional investments in other asset classes. The new Citadel Art Price index offered the opportunity to test this theory in the South African context. The Citadel index uses the hedonic regression method with observations drawn from the top 100, 50 and 20 artists by sales volume, giving approximately 29 503 total auction observations. The Index consists of quarterly data from the period 2000Q1 to 2013Q3. A VAR of the art price index, Johannesburg Stock Exchange all-share index, house price index, and South African government bond index were used. Flowing from the VAR results, additional analyses included variance decomposition, impulse response, and, to determine volatility, variance and standard deviation measures for each index. Results show that, when there are increased returns on the stock market in the previous period and wealth increases, there is a change in the Citadel Art Price Index in the same direction. This finding is consistent with Goetzmann et al. (2009), who reported that there is a strong relationship between art and equity markets and that art price changes are driven by capital gains and losses. No significant difference was found between the house price index and the art price index, and neither between the art and government bond price indices. Overall, the South African art market does not offer the opportunity to diversify portfolios dominated by either property, bonds, or shares.

JEL Classification: Z11, G10

Keywords: Diversification, financial instability, art investment, wealth, Citadel Art Price Index

1. Introduction

Recent South African media reports (Greeley 2013; Kerrigan 2013) have emphasised the need for businesses and households to reduce risk through investment diversification. One such proposed investment option is art, due mainly to the increased volatility of the South African economy following the global financial crisis.

The art market is unlike any other market, from its price discovery and risk and returns to the effect of a consumption component on investment demand, and may thus offer an opportunity for such diversification. When deciding where to invest, comparing conventional assets such as bonds and equities can be done easily, as information on their price and returns is readily available. Art, on the other hand has very little intrinsic value and its value can change depending on individuals' preferences (Goetzmann et al., 2009:2). Frey and Eichenberger, (1995) argue that media reports have given the impression that art investment offers high returns. The rapid increase of art prices in the 1980's and 2000's along with recent art price records being broken all fuel this idea (Renneboog and Spaenjers, 2009). However, due to artwork's inelastic supply and luxury good status, prices can vary greatly depending on taste and current fashions. Demand for art, and the willingness to spend by the

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wealthy, are thus the main determinants of art market activity (Goetzmann et al, 2009; Ait-Sahalia, Parker and Yogo, 2004).

In South Africa, the investment company, Citadel, released an Art Price Index in 2011 to provide more information to investors and give them the ability to compare art investment to other kinds of investment. The index has been in existence for two years and covers the period from 2000 to 2013. South Africa's local art market is small compared to the world market but has seen some substantial growth in the past few years especially with the establishments of new art fairs and galleries. It has a modest number of famous artists that have realised international fame and substantial commercial success, but this does not mean that there are not lucrative opportunities for investment. This paper seeks to discover whether art is a good way to diversify an investment portfolio by analysing the Citadel Art Price Index in relation to movement of the FTSE/JSE All Share Index, the ABSA House Price Index, and the South African Government Bond Index.

2. Art and investment: Theory of the art market

Art indices are released around the world so that the anomalies that exist in art markets along with investment behaviour can be better understood. When observing the art market one is struck by two major difficulties: firstly the diversity of products offered, and secondly the lack of trading, which means that trends become difficult to predict (Renneboog and Spaenjers, 2009:2). However there are methods that scholars have adopted to overcome these problems. With a hedonic regression artworks are "valued for their utility-bearing characteristics" and therefore have the ability to control for quality changes between different works through "attributing implicit prices to specific value-adding characteristics" (Renneboog and Spaenjers, 2009:6). From there the implicit prices of the identifying characteristics are estimated and translated into dummy variables that will help explain the eventual price (Fase, 1996:651). The implicit prices of these characteristics are used to estimate regression coefficients and are "deducted from the effective price of a painting" with the difference averaged annually to create the price of an "ordinary" painting (Fase, 1996:652).

The prices of these ordinary paintings are then captured along with the addition of a time dummy which produces the hedonic price index (Fase, 1996:652). The most challenging part of creating a hedonic price index is identifying which characteristics will have the greatest impression on the price (Renneboog and Spaenjers, 2009:6). The most commonly used characteristics are easy to measure and easy to observe, for example, the artist, medium, size and the auction house the work was sold from while the living status and signature of the artist have been known to be used where appropriate (Renneboog and Spaenjers, 2009:6).

The accuracy of each individual characteristic is important. A study by Higgs and Worthington (2009:122) shows that price was increased if the artist was deceased, if the work was larger, works were in acrylic or oils, and if the work was sold at Christies or Sotheby's. Lower prices were

associated with small etchings or charcoal works created by living artists sold at smaller auction houses (Higgs and Worthington, 2005:122).

The advantages of the hedonic method are that differences in prices between paintings and price movements are easily distinguished and all auction data available is used (Fase, 1996:652). The disadvantages are the assumption that a few characteristics, which do not include talent or artistic quality, are able to capture such large variability in a fixed component such as price and that these characteristics “do not vary systematically over time” (Ashenfelter and Graddy, 2003:767)

Such indices allow for art to be compared to other conventional investments. When comparing art to conventional assets there are two main indicators that investors will consider: the risk of investing and the return that the investment promises. However there are problems when comparing the risk and return on art to conventional assets. Firstly art has both an investment and consumption component to it. Secondly, as Frey and Eichenberger (1995:209) identified, transaction costs, taxation, financial comparisons and data problems are major drawbacks in studies on risk and return in the art market. These problems mean that the accuracy of comparisons between art and other investment vehicles can be questioned.

Frey and Eichenberger (1995:209) showed that the majority of studies use data from auctions, as these data are easily accessible and reliable while disregarding other sales from galleries and collectors that may also have important impacts on price movements (Frey and Eichenberger, 1995:209). These missed sales can have a substantial effect on returns. Most studies also disregard high auction fees and transaction costs due to their variability and the difficulty in calculating them, but because of their size, they play a significant role in returns (Frey and Eichenberger: 1995:209). Previous studies have also not taken taxes into account when calculating returns as taxes vary greatly between periods and countries (Frey and Eichenberger, 1995:209).

When comparing art to conventional assets there are two main indicators that investors will consider - the risk of investing and the return that the investment promises. Risk is the uncertainty about the return an investor will receive on an asset, while return measures how well a person has done by holding that asset. Risk can thus be defined as the probability that the expected return is different from the actual return (Howells and Bain, 2008; Mishkin, 2010). In this case, risk can be estimated by measuring the volatility of returns over the period (where a riskier asset is defined as one where there is a wide dispersion of returns around the mean). An analysis of the variance or standard deviation of the different asset classes thus gives an indication of risk, while mean values show what the investor can expect to earn over time.

Risk and return on art investment is atypical however, as it has both an investment and consumption component to it. Art is a hybrid of consumption and investment (Mandel, 2009:1657), which makes it difficult to compare the return on standard financial assets to the return on art, since

the difference in return may be capturing the value that the owner receives from owning an asset that is also a consumption good (Throsby, 1994: 6).

People that purchase art fall into three categories or motives in terms of their purchasing decisions: intrinsic motives (the derivation of aesthetic value from the artwork); as a signal of wealth; for investment purposes; or some combination of these (Mandel, 2009:1653). With reference to intrinsic value, it is difficult to predict varying taste and therefore consumption decisions. The income and wealth of the person who desires the artwork would be the only constraint to the consumption decision (Goetzmann, 1993:1375). Art as a signal of wealth suggests that demand could be seen as a form of conspicuous consumption, or to create a sense of cultural accomplishment through the purchase of artworks, which means that the purchase of the artwork has nothing to do with the intrinsic value of that good (Mandel, 2009:1656; Shipman, 2007:279; Braun and Wickland, 1989:162). Art purchasing may thus not always conform to consumption theory, which assumes a fully informed and rational economic agent.

The last motive, purchase for investment, also does not follow conventional investment motivation. The fact that art has the potential for resale and that price can fluctuate over time means that art has some of the same features as financial assets, in that it can be used to protect against inflation, as a source of capital gain and a store of wealth (Throsby, 1994:4). However the way that artworks derive their value is different to other financial investments as art is a durable consumption good as well. Mandel (2009:1654) states that the demand for an artwork as a financial asset will fulfil the need for savings while also proposing that art carries a "utility dividend" which increases the value of art as an asset. Stocks represent a claim on the asset that provides a monetary return to the owner over a period, while an artwork provides a monetary return at the end of the ownership period as well as providing aesthetic value and social prestige to its owner (Goetzmann, 1993:1375).

Another aspect of an artworks price within financial markets that distinguishes it from other financial assets is that the supply is fixed (Fase, 1996:650), which means that the price is fully determined by demand (Fase, 1996:650). Therefore at the given price of an artwork the buyer will face a trade-off: "the utility of giving up consumption to buy a piece of art exactly equals its expected conspicuous consumption benefit plus capital return next period" (Mandel, 2009:1657). Thus an art asset's payoff will be increased by the utility dividend and art investors will not need to be compensated by as much in financial terms as conventional financial assets (Mandel, 2009:1662). Art market activity can thus be influenced by many different forces and art investment may thus offer a good vehicle for portfolio diversification.

Goetzmann et al. (2009:8) conducted a study that sought to discover whether there was a relationship between equity markets and art markets and whether this relationship affected prices and activity in the art market. For their analysis they created an art price index from 1765-2007 of which

1,468 were observed repeat sales. They built an index of British stock price returns for the period that covered dividend return, total return and capital appreciation, which compared to the art market returns. Results showed that there is a strong relationship between art and equity markets and that art prices are driven by capital gains and losses (Goetzmann et al., 2009:16). This finding is supported by Chanel's (1995:527) work: "It would appear, then, that financial markets react quickly to economic shocks, and that the profits generated on these markets may be invested in art." These results thus demonstrate that when wealth increases, especially that of the wealthy, the price of art can be expected to increase, creating the possibility of increased art market activity and an art boom (Goetzmann et al., 2009:16).

Mei and Moses (2002) used a repeat sales regression to calculate an index of 4896 sales pairs from 1950 to 2000 for the American art market. Their results showed that the art investment offered better returns than corporate or government bonds, and was less volatile. However, Renneboog and Spaenjers (2009) used a hedonic regression compiled using more than 10 000 artists, including 1.1 million transactions. They compared the index to other markets for the period 1951 to 2007. Their results showed that art did not perform as well as stocks (S&P 500 and the GDF Global Equity Index) and that the reward to risk ratio was higher for stocks than for art. The art index did however have a better reward to risk ratio than government bond indices.

Frey and Eichenberger (1995) argue that, rather than comparing art investment to bonds and equities, they should be compared to assets like land and property, which are closer substitutes due to similar liquidity issues, holding periods and, in many countries, benefit from special tax treatment.

3. Data and method

The four variables used to test the hypothesis that art investment is a good way to diversify an investment portfolio in South Africa are the FTSE/ JSE All Share Index, the Citadel Art Price Index, the Absa House Price Index, and the South African Government Bond Index. One of the main reasons for the release of the Citadel Art Price Index was an identification of the need to help improve investors' search for assets that provided the ability "to improve risk-adjusted returns and to diversify their financial portfolios" (Citadel, 2011:4). Citadel thus adopted a hedonic regression as they believed it gave their index the ability to overcome two key difficulties when evaluating the art market: the diversity of artworks and the infrequency of trading (Citadel, 2011).

Citadel's observations start from 2000 and the sample was drawn from the top 100, 50 and 20 artists by sales volume, argued to be an appropriate outline of the general market (Citadel, 2011:10). The top 100 included 17 997 auction sales representing 61% of total trades and 87% of total sales revenue (Citadel 2011:10), giving approximately 29 503 total auction observations. All data are quoted quarterly from the period 2000Q1 to 2013Q3. This period was chosen due to the availability of the Art Price Index for this period. The logged values of the series are presented in Figures 1 to 3.

Table 1 reports some basic descriptive statistics of the four indices. While the mean return is highest for the all-share index, the art price index is the most volatile of the various asset classes. Thus, investing in art appears to be the riskiest option. Table 2 contains correlation coefficients between the variables of interest. The share prices and art prices are significantly positively correlated, thereby suggesting little value for investing in art as opposed to shares.

This paper estimates a VAR of the Art Price Index, the Absa House Price Index, the South African Government Bond Index, and JSE All Share Index. Flowing from the VAR results, additional analyses include variance decomposition and impulse response. Variance and standard deviations are also used to comment on volatility, as an indicator of risk.

Table 1: Summary statistics

	All-share index	Art price index	Bond price index	House price index
Mean	0.0311	0.0168	0.0274	0.0282
Median	0.0463	0.0092	0.0286	0.0339
Maximum	0.1581	0.3534	0.0822	0.0821
Minimum	-0.2184	-0.2709	-0.0605	-0.0266
Standard deviation	0.0784	0.1337	0.0301	0.0241
Skewness	-1.1169	0.3836	-0.4826	-0.2130
Kurtosis	4.1332	3.7652	3.0851	3.0738
Jarque-Bera (p-value)	14.1172 (0.0009)	2.6413 (0.2669)	1.4792 (0.0479)	0.4207 (0.8103)

Table 2: Correlation coefficients

	All share index	Art price index	Bond price index	House price index
All share index	1.0000			
Art price index	0.3927***	1.0000		
Bond price index	-0.2706**	-0.0806	1.0000	
House price index	0.2005	0.1412	0.0816	1.0000

*Note: *** and ** denote significance at the 1% and 5% levels, respectively.*

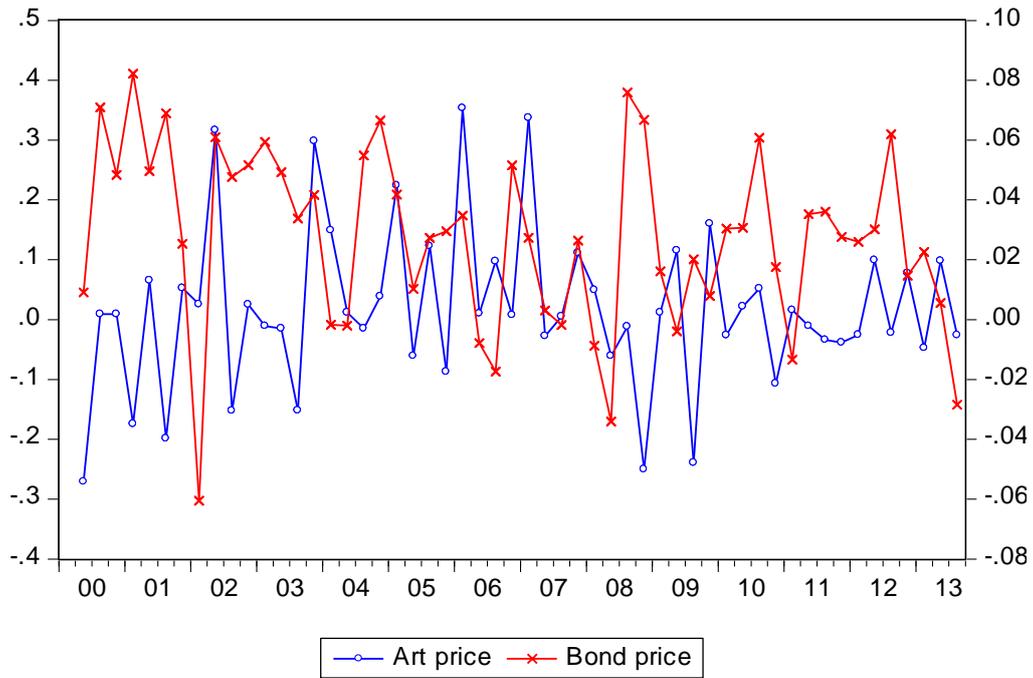


Figure 1: The Citadel Art Price Index and the South African Government Bond Index

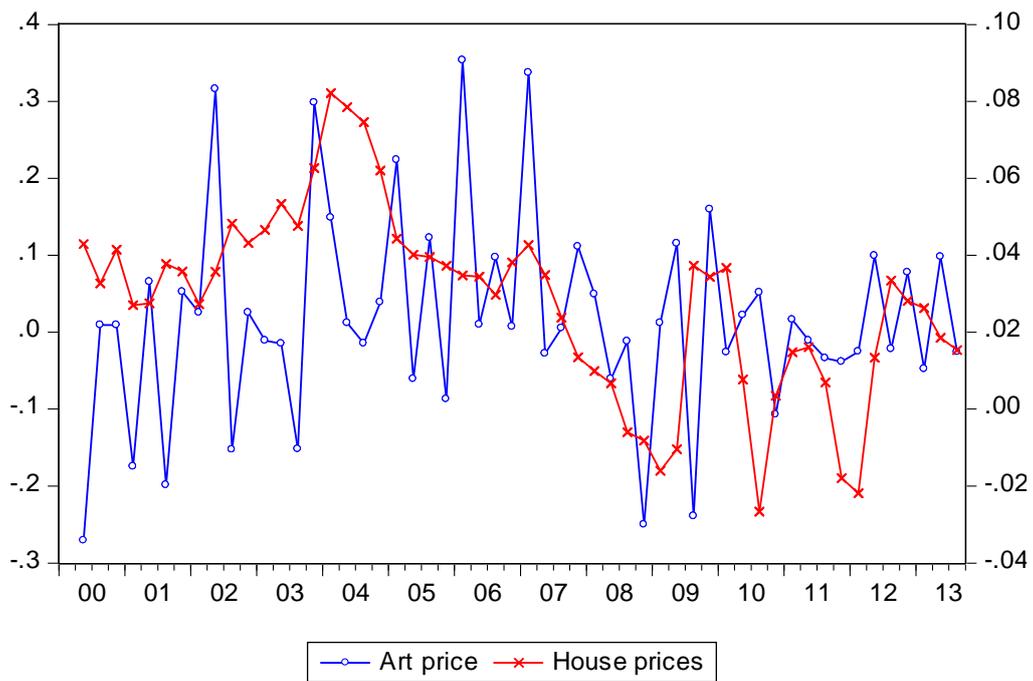


Figure 2: The Citadel Art Price Index and the ABSA House Price Index

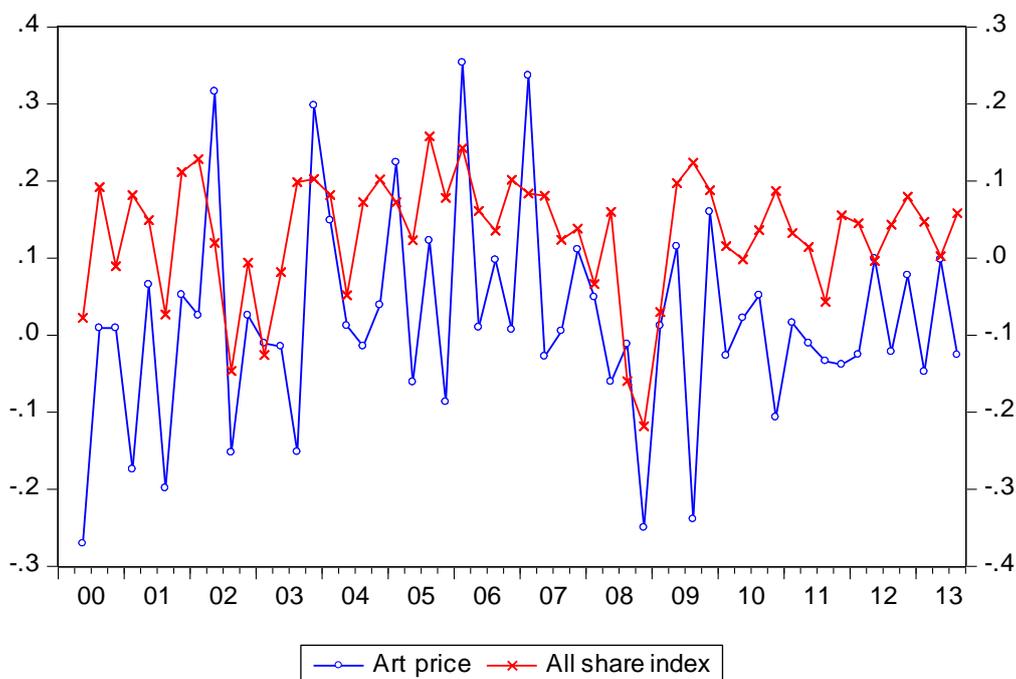


Figure 3: The Citadel Art Price Index and the JSE All Share Index

4. Results

The lag length information criteria suggested the use of one lag as appropriate for the VAR, the results of which are reported in Table 2. Results show that the lagged all share index within the art price index equation is positive and statistically significant, indicating that the art price index rises by about 0.68% for each percentage increase in the all share index.

The lagged house price index is positively but not significantly related to the art price index. This also confirms expectations by Frey and Eichenberger (1995) that art investment may be more like illiquid land and property investment. The lagged government bond index, moreover, is negatively related to the art price index. Though investment in art could thus potentially offer an effective portfolio diversification strategy for portfolios dominated by South African government bonds, the relationship is not statistically significant.

Impulse responses (Figure 4) show that art prices react positively to a shock in the all-share index, which dies out after roughly six quarters. A Granger causality test further reveals that changes in the all-share index Granger cause changes in the art price index ($p < 0.01$), but art prices do not Granger cause changes in the all-share index ($p > 0.05$). In addition, variance decomposition analysis showed that, after ten quarters, the art price index explains roughly 81% of its own variance, while the all-share index and house prices explain about 15% and 3% of the variation in art prices, respectively.

As a whole, therefore, when there are increased returns on the stock markets in the previous period and wealth increases, there is a change in the Citadel Art Price Index in the same direction. This finding is consistent with Goetzmann et al. (2009:8), who reported that there is a strong relationship between art and equity markets and that art price changes are driven by capital gains and losses. Since

art is a luxury good it would be expected that, when people become wealthier they invest in art as a means of savings, or as a status good (Braun and Wickland, 1989:163).

Table 2: VAR results

	All share index	Art price index	Bond price index	House price index
All share index _{t-1}	0.3596*** (0.1484)	0.6811*** (0.2229)	-0.0673 (0.0594)	0.0383 (0.0270)
Art price index _{t-1}	-0.1411 (0.0828)	-0.4516*** (0.1244)	-0.0406 (0.0331)	0.0183 (0.0150)
Bond price index _{t-1}	-0.1373 (0.3652)	-0.4538 (0.5485)	0.0973 (0.1461)	0.0339 (0.0663)
House price index _{t-1}	0.4776 (0.4359)	1.1208 (0.6548)	0.2105 (0.1744)	0.7842*** (0.0792)
Constant	0.0149 (0.0187)	-0.0096 (0.0281)	0.0218*** (0.0075)	0.0032 (0.0034)
Adjusted R ²	0.0974	0.2595	0.0465	0.6934
F-statistic	2.4031	5.5548	1.6334	30.4036
LM(1)		0.1699		
White		0.6662		
JB Normality		0.0703		

Note: *** denotes significance at the 1% level. Value for the LM-test reflects the p-value associated with the null hypothesis of no serial correlation at the first lag, whereas the White test's value is the p-value related to the null hypothesis of no heteroscedasticity. The p-value of the JB statistic relates to the null hypothesis of normality.

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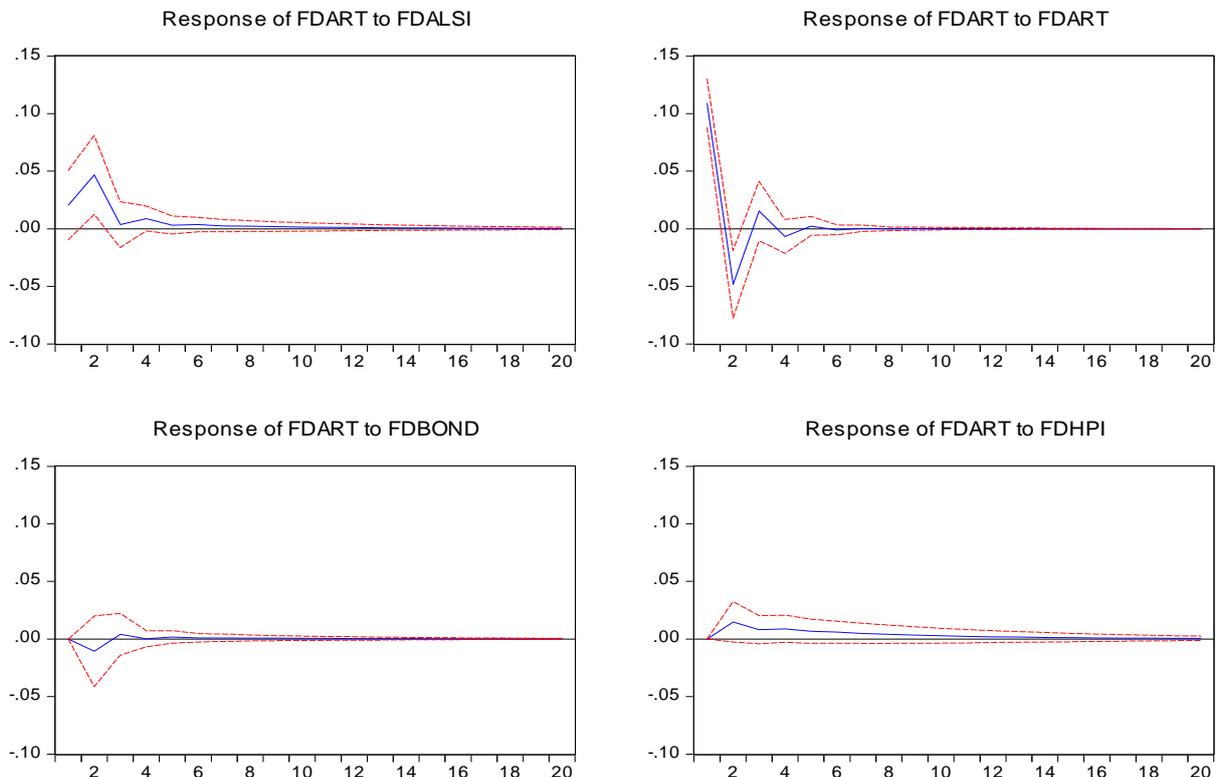


Figure 4: Response of art index to innovation in all-share index

5. Conclusion

This paper set out to test whether art is a good way to diversify an investment portfolio, by analysing the changes in the Citadel Art Price Index in relation to the movement of the FTSE/JSE All Share Index, the Absa House Price Index, and the South African Government Bond Index. Results show that part of the returns on the FTSE/JSE are reinvested into art and that art thus does not seem to offer a good way to reduce risk in an investment portfolio dominated by shares. Investing in art also seems to be the most risky of the four asset classes, followed by shares. Although the art price index is negatively related to the South African government bond price index, thereby suggesting that art offers a way of diversifying a bond portfolio, the relationship is not significant.

Some limitations are worth noting. First, the Citadel Art Price Index only includes auction data and thus can create a biased view of the art market. By not including gallery sales within the index, the index leaves out a large portion of the art market (Frey and Eichenberger, 1995). Secondly, dividends are not included in the calculation of the FTSE/JSE All Share Index; a large portion of return on investment is thus excluded. Avenues for future research could include acquiring sales data from galleries to provide a more comprehensive overview of the South African art market. Being able to compare the South African gallery system to the auction system may enable an analysis on the efficiency of the local auction system.

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