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Is Art the Next Boom Investment?
The Market for Major Works Is Heating Up, but Small Investors Can Get Chiseled
By MARY PILON

On May 4, Pablo Picasso's "Nude, Green Leaves, and Bust" sold for $106.5 million at Christie's in New York, setting the world record for any work of art sold at an auction. Which has art-loving investors wondering: Is the art market exiting its recession?

If theft is any gauge of popularity, they can take heart: Five multimillion-dollar works, including pieces by Picasso and Henri Matisse, were found missing from Paris's Musée d'Art Moderne early Thursday.

"It looks like the art market is starting to come back," says Michael Moses, a retired professor at New York University's Stern School of Business and co-creator of the widely followed Mei Moses All Art Index. The art world tends to trail the stock market by six to 18 months, he says, which suggests there could be more upside later this year.

But those hoping to swoop in on a nascent rally should be aware that even the most beautiful art can carry major blemishes as an investment. "Just like stocks, there are parts of the art market that will perform differently," Prof. Moses says.

In fact, the term "art market" is a misnomer, says David Kusin, founder and president of Kusin & Co., a Dallas-based research firm focused on fine art, decorative art and antiquities. "It's a series of micro-markets that aggregate the market," he says.

For example, prices of post-war and old-master works increased by 19% and 17%, respectively, during the first quarter, according to various smaller Mei Moses indexes. But American works created before 1950 declined by more than 30% over the same period.

All told, art lost 5% of its worth in the first quarter of 2010, according to the All Art index, which tracks prices by analyzing some 15,000 repeat sales at auctions. The index plunged 35% during the same time last year. The index tracks only a sample of works that have proven themselves in the marketplace by being sold and resold, so it may not give a complete picture of the entire art market. It does not track the prices of works that have been bought but not resold or haven't been put on the market at all.

Mr. Kusin cautions anyone with less than $20 million in cash to avoid investing heavily in art. "Art investment is a black hole," he says. "From the moment you buy or sell, there are ongoing costs. As an owner, you have to be realistic."

Instead, he says, you should "buy because you enjoy what you're doing or are passionate. But don't cloud the issue by claiming to invest."

Among the costs of doing business: auction fees, or costs charged to a seller and buyer by an auction house. They vary widely, but can be 20% of the price or more. Such fees, typically printed at the front of an auction catalog, can sometimes be negotiated, and buyers and sellers can sometimes organize bulk discounts, but costs have generally risen over the past few years and show few signs of letting up. Steep specialized transportation, maintenance and insurance costs can also eat into projected returns.

Hedging Risk

Art can be used to reduce risk in larger portfolios, but it is typically not a liquid asset. Generally, works are often held onto for several decades or even generations, and a painting can rarely be unloaded as quickly or easily as shares of stock.

And then there are the tax considerations. Art is generally treated as a collectible, like jewelry or wine, making it subject to a 28% capital-gains tax when sold, as opposed to the current maximum 15% long-term capital-gains rate for investments like stocks, says Nadine Gordon Lee, a CPA and president of Prosper Advisors in New York. Art is also subject to sales taxes—if you buy a painting in London and live in New York, say, you are on the hook for sales tax bill when you come back home.

You will also need to reappraise any artwork when it becomes part of an estate or is given away, and owners must keep detailed documentation of a work's history to prove estate tax has been paid on it in the past in order to resell it at an auction. "You can't just take something off a family member's wall," Ms. Lee says.

Private Funds

Some investors, mostly ultra-high-net-worth or institutional ones, can invest in funds that buy and sell art. The Fine Art Fund Group, a London-based investment house, has $100 million under management and offers funds that specialize in areas such as fine art, Chinese art and Middle Eastern art. The firm may buy and hold work for one day or 10 years, says Fine Art Fund Group founder and CEO Philip Hoffman.

The fee structure is similar to that of conventional hedge funds, with the firm charging a 2% management fee and a 20% performance fee after the funds earn a 6% return. Minimum investments range from $100,000 to $250,000.

Like stocks, some art sectors will rise and fall at varying rates, says Rachel Edelshteyn, president of the Board of Investment Art, a Chicago-based consulting group. Investors should diversify within an art portfolio. Valuing different art classes and how they complement each other can be a tedious exercise in cobbling together numbers from auction houses, sellers and other sources.

And, quite simply, tastes evolve.

"Years ago, no one would have bought a late Monet," says Renée Vara, an art adviser and collection manager with Vara Fine Arts in New York, referring to the artist's later works, when he began to lose his sense of sight. "Those were considered bad. Now, I like them because they're abstract. People's aesthetics can change."