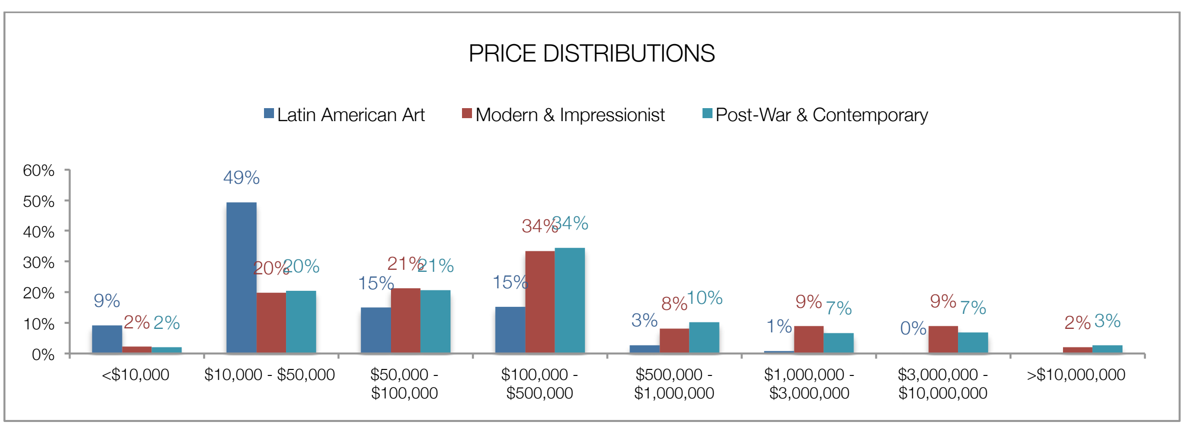
Asset Pricing: Art

Asset pricing has become one of the main pillars of modern financial theory and everyday financial use. Mainly because knowing the correct price of an asset is the only way to measure and therefore estimate risk and return degrees. Moreover, these measurements are indispensable when securitizing assets into financial instruments. Art as an asset does not escape from this premise; art cannot be considered an investable asset if it is not properly valuated. However, despite what many investors fear every artwork can be accurately priced.

Valuating art is the process of attributing a monetary value to artworks in a certain point in time considering all of its physical and non-physical aspects. Considering art's heterogenic characteristics as an asset is not a simple process, it requires quite a lot of expertise to fairly price an artwork's inherent characteristics and aesthetic value. Like with any asset, the price represents where the supply-and-demand market forces have met via a fair/unfair, or efficient/inefficient, mechanism. However, a very thorough valuation does not only price the artwork regarding its market, it evaluates the artwork as a whole.

Traditional financial assets are usually priced by adding their expected future cash flows discounted by an interest rate. Nevertheless, with art this is almost impossible and if it were possible it would be very inaccurate. From a financial perspective, art by itself does not offer any constant cash flows; its financial return derives only from capital appreciation through time. Considering that art is also a consumable asset in a sense that one consumes an aesthetic experience every time one enjoys the work of art, a possible but imprecise way to quantify future cash flows would be to estimate how much an individual would be willing to pay to view and enjoy an artwork for a certain amount of time.



Given the aforesaid difficulties art is usually priced by comparative analysis just as with real estate. Investors might consider the process of pricing aesthetic aspects as a subjective or arbitrary process. However, in recent times it is less complicated than it sounds because several electronic databases have compiled millions of sale prices from public auctions that provide a solid historic portrait of an artwork's market. Furthermore, econometric and statistical tools have been successfully adapted to accurately estimate prices, and therefore market tendencies, taking into consideration an artwork's relationship to the entire artist's production and current market.

When selecting price references to compare an artwork, a lot of attention must be paid to "Bought In" (BI) artworks. These are artworks that were placed in the auction market and failed to sell. There are many reasons why artworks fail to sell, like an incorrect presale estimate or lack of quality; however, in general, a BI artwork represents an absent or low demand for that type of artwork. This effect can be translated into risk, or artworks' specific risk. The after-auction consequences of a BI are quite important in the artwork's track record (for further insight in BIs read http://bit.ly/MErOrz). Many price estimations make the mistake of not taking BIs into consideration and thus leave out an important market fact.

Traditionally, in order to calculate the fair market value of an individual artwork a sample of peer artworks is selected from auction records. The comparable artworks are selected because of their similarities in author, theme, medium, size, year of creation, provenance, etc. Only auction price records are used because they are publicly available and are the most "reliable" of the market; gallery or direct-from-artists prices tend not to be trustworthy, or obtainable. Using the comparable set of artworks a base price is calculated by averaging their prices. Consecutively, this price will be increased or decreased considering specific facts like the provenance, price track record, condition of the artwork and number of restorations, academic studies of the artwork, previous exhibitions, flagship of the artwork, etc. It is of utmost importance to perform all of these analyses within the appropriate predetermined classification nomenclature of each concept.

Another relevant subject is valuating an entire collection. When pricing an art collection one must keep in mind that the whole is larger than the sum of the parts. Good collections usually include every artwork for a purpose. Experienced collectors usually have guidelines or parameters that guide their acquisitions and in a way reflect their motivation or impulse behind their passion for art. A well-balanced collection will usually include an additional premium that reflects the collector's effort of gathering each artwork.

Traditionally, it has been argued that despite the academic efforts to appraise artworks by implementing financial and economic models, an expert eye could be more precise in most cases. This in fact is not true. The objective of applying financial models in the art market is not to disregard or discredit art experts, it is mainly to help improve transparency and promote efficiency in a developing market. A combination of these two areas of expertise would be the optimal scenario when valuing artworks. Econometric and financial analysis has proven to succeed when the trained eye meets its end. In the last years, this has been the constant goal of institutionalized forms of art investments like art funds.

Given the importance of correct art valuations, the only way for the art investment sector to evolve is by having accurate and efficient valuation methods. Art as an individual asset will not become a structured and institutional investment vehicle if it is not properly valuated. Hence, the core of the industry's maturity relies in the development of a financially acceptable asset-pricing method that promotes transparency.