Spotlight #3 Scott Lynn: Securitized Investment in Fine Art

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Erik: MacroVoices Spotlight Episode #3 was recorded on May 10, 2020. I'm Erik Townsend. Today's topic is fine art investing. Joining me is Scott Lynn, founder and CEO of Masterworks.

Scott, it's great to have you on the program. Frankly, this is one asset class that I don't know very much about. I see a lot of really big-name hedge-fund managers and people in finance are clearly moving into major purchases in fine art.

I'm guessing that that's driven by the same reason that the same people are looking at gold and real estate, which is they want hard assets that are independent of the financial system. But you're the expert on this.

Why don't you tell us in your own words, why fine art? Why is this suddenly becoming so popular with so many big names in finance?

Scott: Sure, thanks for having me, Erik.

You know I think there's two things about art as an asset class that people tend to gravitate towards. The first, very high-level obviously, is returns. Depending on the segment of the market you look at, the returns are very interesting.

What we define as blue-chip art, which is art created by the top 100 artists, has historically appreciated at about 8.9% a year for the past 20 years. So the returns overall are very interesting.

But maybe even more unique is the lack of correlation. So Masterworks did a correlation study with Citigroup at the end of 2019. And we found that the correlation factor between art and the S&P was roughly 0.13.

So it's a very high-level, it's an asset class that has comparable if not better returns to public equities and is also uncorrelated.

Erik: Help me understand the returns of art relative to something like the S&P. I'll just tell you

I was shocked when I looked at the chart on your website at Masterworks. You're showing that the fine art index has consistently outperformed the S&P 500 over a period of several years.

I don't understand this. The S&P 500 is productive companies that are running the economy. It's where corporate profits in the whole economy come from. The investor is buying a piece of that corporate engine.

Art is obviously something that people treasure and value highly, but it's not producing jobs and income and so forth. How is it possible that it can produce these return?

Scott: We ask ourselves this question, obviously, a lot. And it is the million-dollar question. Our research team has spent thousands of hours on the topic, probably.

We don't have a precise answer, but our best hypothesis is that art prices are correlated to global ultra-wealth creation. Art obviously is an asset class that you can move between countries. It's not country-specific.

But at least the high end of the art market is really bought and collected by ultra-ultra-high-net-worth people. So if you believe that that segment of the population continues to get wealthier over time, then you can come to the conclusion that art prices will continue to increase.

Erik: And how big is this market in terms of transaction volume?

Scott: Art as an asset class overall is estimated to have a total asset value of about $1.7 trillion. And that's a number that's published by Delloyd and has been indirectly confirmed by Sotheby's. Last year, roughly $68 billion in art sold. And roughly half of that sells at public auction and half of that sells privately.

Erik: And is the auction mechanism – tell us about the market for art. Obviously most people think of an auction, the Sotheby's type of auction where there's a bunch of wealthy people bidding on art.

Is that pretty much the way the market works? Or has it become more modernized than that?

Scott: Modernized is probably the wrong word for the art world. It's more or less operated the same way for centuries. Half of the market is public auction. And, at least in the US, that means Christie's, Sotheby's, and an auction house called Phillips.

The other half of the market is really driven by galleries. And those are large galleries and it goes into very small galleries that operate in New York City and other areas.

So, broadly speaking, that's how art is sold.

The interesting thing about the auction market, which many people don't understand, is it provides a huge amount of transparency into the asset class to really understand the performance over time.

Art has been sold publicly at auction for hundreds of years. Sotheby's, which was publically traded on the New York Stock Exchange (it just recently went private), is 275 years old. You have this very unique data set where you can go back for centuries and analyze what certain paintings by certain artists were selling for over time to understand returns.

So it's very similar to real estate in that respect, that you have a public dataset of prices and what things were selling for.

Erik: Okay. So the correlations to other asset classes are very favorable, it's very independent. So, in terms of constructing a diversified portfolio, it seems to fit in.

Obviously, if the returns are better than the S&P and there's really good correlation characteristics, then there's got to be something wrong with it. So I'm guessing that the downside is liquidity. That if you buy a particular piece of fine art it might be a while before the next guy comes along who wants that particular piece of fine art.

Is a liquidity premium, is that the reason you're seeing these excess returns and so forth? Or is there some other aspect to it that I'm not seeing?

Scott: I think there's a couple of obstacles to adding art as an allocation to a portfolio. One obviously is just the price for what we would consider to be an investment-grade painting. Most investment-grade paintings that we look at are upwards of a million dollars.

So when people think about allocating 2-3-4% of a portfolio to art, obviously you have to have a very large portfolio for that allocation to make sense. And you have to have a lot of knowledge about the art market.

Secondly, as you mentioned, it is an illiquid asset class. We tell our investors to think about a three- to seven-year hold when they're investing in any particular painting Masterworks launches. And that historically has been a concern.

One of the things that we've launched recently, which I find really interesting, is a trading platform on Masterworks. So, in addition to investing or purchasing shares in particular paintings, investors are now also trading shares. So it's very similar to other asset classes. We're allowing interim liquidity through that trading platform.

Erik: Now, I can imagine that, just from what we've discussed so far, it seems like there's a lot of value to this asset class. And I would think that someone you just mentioned being an art expert or an expert in the art world, I've got to believe that an expert in the art world like yourself could really do incredibly well in this asset class.

The thing is, I'm not that guy.

So for an investor who appreciates the value that this asset class brings to a diversified portfolio, but is not qualified to be the expert, where does that leave you? What are your options? And I certainly don't want to go to any auctions and tell you, I like that one. I'm not the right guy for that.

How do we navigate this market for investors who are not experts?

Scott: Maybe taking a step back, let me talk a little bit about our research team and how we've approached understanding art market returns.

Many of your listeners probably invest in real estate and they're probably familiar with Case-Shiller, which is an index that tracks real estate returns.

We've taken a very similar approach to understanding the art markets. We have a research team that's gone out and found over 60,000 times that a particular painting has been purchased and then subsequently resold at public auction. And what the return was on that individual transaction.

And from those 60,000 transactions we've been able to construct indexes on the art market overall, understand returns by segment, understand returns by artist market. And we publish that data to our investors when they're investing in a particular painting.

So if we launch a painting, for example, by Claude Monet, we'll tell you the historical returns for Monet's market, we'll tell you the historical returns for similar paintings. We actually risk rate each artist that we bring to the platform to understand the risk level as well as the return.

So I think our perspective is very data-driven. We try to present as much data to investors as possible to make individual investing decisions, so they rely less on us as a manager.

Erik: Let's talk about the strategy or the approach that an investor should use in buying art.

Because if I draw an analogy to the stock market, there's a lot of different ways to skin a cat. Some people prefer to invest only in blue-chip stocks, the big well-known companies that nobody questions their prominence in the market.

Another approach is to only buy small tech startups, hoping to catch that hot story that's going to become the next killer app on the internet.

How do you approach the art market? Is this a market where you're looking for the up and coming artist that nobody's ever heard of? Or are you better to stick with the well-established names?

Scott: There's three segments of the art market that we talk a lot about.

One is what we define as blue-chip artists. And that's primarily your artists that have transaction volume in excess of $100 million a year. So these are artists that you've heard of, artists like Picasso, Monet, etc.

The next category of artist that we like and we find interesting are what we refer to as established, primarily living artists. So these are mid- to late-career artists who sell in excess of $30 million a year.

And then you have emerging artists, which is the third bucket that we don't really focus on today, mainly because we just view it as too speculative and that there's not really enough data to really predict returns.

So the first two buckets we tend to tell investors – you know it's interesting when we look at the returns, obviously, in the established bucket for mid- to late-career artists, they tend to range between 12 and 20% but with a higher standard deviation in return or risk.

Blue-chip artists tend to range between 8 and 12%, with a lower standard deviation in returns. So therefore they're lower risk.

When we look at the risk-adjusted returns, and the Sharpe ratio on both of those buckets, it's actually roughly the same. So there's not necessarily a good choice or a bad choice between those two different buckets. It really just comes down to the investor's absolute risk tolerance and what they're trying to achieve in their portfolio.

Erik: Now, let's talk about the options that exist and the new ones that you're creating. Because what you described a few minutes ago is for the ultra wealthy, for the people who can just take 2 or 3% of their net worth and buy $10 million paintings with that 2 or 3%. They're hanging out at the auction house. I'm not that guy.

So the usual solution to this problem when we talk about other asset classes is securitization for a manager to buy whether it be private equity or real estate, apartment buildings, whatever it is that you want to invest in.

If you can't buy an apartment complex out of your own pocket, you buy into a REIT (or a real estate investment trust) where somebody is managing that.

I would think that in the art world, if I were to personally buy a classic painting, first of all I've got to know which one to buy and not get taken for a ride on buying it. I don't have that knowledge and experience.

Then I need to take care of it and not damage it in the way that I store it and so forth. I don't know how to do that.

And eventually somebody who knows the market needs to know when it's time to sell it and where and how to sell it. And I'm not that guy either.

So, as I understand it, what you guys are doing is basically securitizing the art world. How does that work? How did this idea come up? What are you doing and how does it work?

Scott: That's a great question. I've been starting tech companies for the past 20 years but also collecting art at the same time and have built an important mid-century collection here in the US.

And I just found the asset class really, really fascinating. It exhibits all of those return characteristics we were talking about. I think we've proven now today that it's uncorrelated to other asset classes.

But the barrier to entry to invest is really high. I mean you have to be passionate about art. It's millions of dollars to build out a portfolio. Obviously, portfolio construction is really difficult when you're talking about $10 million paintings.

So I had this idea to securitize the asset class so that anyone could allocate a portion of a portfolio to it. And I think what we've seen is there is just huge investor demand around that.

So Masterworks was the first company to take a painting, drop it into an LLC, and effectively file that LLC as a public offering with the SEC. So today you can go to the SEC's website and search for Masterworks and see all of these different single painting offerings that we've done, which is kind of cool.

It's very similar to reading a public offering on a company like Uber. But you're really reading about how we're taking a painting public along with risk disclosures etc.

Erik: Fascinating process, because in a lot of startup companies the way it works is the investor is exposed to some kind of pitch. If we think about what angel investors do, they go to a pitch meeting with the entrepreneur who says I've got this idea to start this company to do such and such. And in that case, they know what they're buying.

But a lot of times, when you invest in a fund, you don't know what they're going to buy. You're putting the money up and the fund, the manager has got the money. And then they go and invest it in whatever the asset is.

So initially my assumption when I heard about Masterworks was going to be that you guys must be running like an art mutual fund where I buy shares in the fund and then the fund goes and buys a number of different paintings which are held as a group.

You don't do it that way. You're actually securitizing the individual paintings. But you've bought the paintings before you securitize them.

So how does that funding process work? Talk us through start to finish, this transaction.

Scott: So Masterworks goes out and purchases paintings with balance sheet capital. And that's really important in the art market because, for a whole host of reasons, moving fast, negotiating quickly is really critical. So we buy the painting with our own capital.

And we turn around and we effectively sell it off to investors on the Masterworks platform for purchase price plus fees. And our fees are 1-1/2% per year plus 20% of profit when a painting sells. So very similar to a hedge fund structure.

It's a very straightforward process. Investors can see the painting on the website. They can review the historical returns for that artist market. They can review the historical returns for similar comparables. They see our risk rating – we define different classes of risk – and then make individual painting-by-painting decisions on what they'd like to invest in.

Now we are for larger investors starting to work on portfolio construction tools. So if someone comes to us and says I have this particular investment objective I want to achieve, sort of this return profile with this risk profile, we can guide them to a handful of artists that they can allocate to over time. And then as we launch those artists on our platform, we effectively just call capital.

Erik: Okay, so you're starting with your own money and you buy a painting. You then basically put that into an LLC and you're allowing your investors, you're not marking it up and doubling your money or anything.

You're taking what you paid for it plus an openly disclosed fee structure which is similar to a hedge fund management fee. 1-1/2% management fee plus 20% carry on whatever profit ends up being made.

People buy into that painting, basically taking it off of your books. That replenishes your capital so you can go buy the next painting for your investors for the next deal that comes along.

You've got investors then in this LLC. So they're actually equity owners of that painting.

Now, how does that work? Obviously the investor does not take physical possession of the painting because there's lots of other guys that are in the LLC. Where does the painting go? Is it lent to a museum or something? Or what happens to it?

Scott: It really today primarily just sits in storage. We do work with artist foundations or estates to essentially collaborate with them if they'd like the paintings to go to a museum show or something like that that benefits the artist. But generally today the paintings are staying in storage.

And those investment vehicles are bankruptcy-remote vehicles from Masterworks, so they're really independently owned by the shareholders. Then there is just an administrative agreement between that entity and Masterworks. It's essentially to just store and insure the painting.

So it's a relatively straightforward structure.

Erik: Okay, so if I'm the investor, essentially you're the art expert. You have a team of people who have decades of experience in this field of buying fine art. You guys take your own money, you go buy the painting, whatever you think is a good deal.

You then are compensated similar to a hedge fund with a percentage of your investors' winnings. So you're incented to make sure the investor gets a good deal. If the investor wins, you win, in terms of getting your carried interest out of the deal.

Who decides when it's time to sell the painting? And what drives that? Is it based on market conditions? Or is it based on need for liquidity or what?

Scott: We decide when to sell the painting. And I would think of that in the art market really as almost an event-driven decision-making process.

So, generally speaking, the time to sell a work of art is when there is activity around that artist market. So if the artist is setting a price record at auction, if the artist is having a retrospective, you know whatever those events are that lead to lots of interest in that artist at a given time.

So it is important to always be ready to sell a painting. And that is a role that Masterworks essentially owns in this process.

Erik: Okay, so you are the expert who knows what to buy and when to buy it. It's not a question of a blind buy on the part of the investor. The investor knows what painting they're buying a piece of. They've seen the picture of the painting and so forth.

They buy into that. And then they're entrusting you to watch the market and know when the exit opportunity is most ripe to sell that painting and perhaps then move on to the next one or what have you.

Is there any way for an investor who wants liquidity – suppose that I love the work that you're doing but I just need money to send the kids to college or something? Is there a way to get out of that investment before you sell the painting?

Scott: Completely. This comes back to the trading platform that we launched two or three months ago now. And there's already quite a bit of activity on it. But over time that is our vision for liquidity is investors who are seeking liquidity can really just go to the trading market and make offers to buy or sell shares.

Erik: Okay, and so also if you missed a painting, if I look at your portfolio and it's, oh my gosh, I just love that painting I want to be part of it, there may be an opportunity for me to buy shares even after the first deal is done. After you've sold it to your investors, I may have an opportunity to buy it from your investors if I want to be part of a specific deal that's already occurred.

Scott: Yes, and we're seeing that a lot. So, as an example, we launched a Banksy offering maybe four or five months ago. Every offering we do is essentially priced at $20 per share, independent of the value of the painting.

And I think right after we launched and completed that offering – many of your listeners may know that there is a Banksy painting that sold in the UK right around the time of Brexit for I think $11 or $12 million, which really set a new record for his market and brought up the value of a lot of works.

So we're seeing shares now for that Banksy painting trading up 20-30% I think less than six months after that offering. So it is definitely interesting to watch how that trading activity tracks the art market.

Erik: Let's talk a little bit more broadly about what's happening in this space. Because it seems to me like it's such an obvious idea and it's so ripe for some kind of securitization.

Because, as you say, clearly, fine art is an asset class that some of the smartest minds in finance want to be part of. It's very clear that that's a trend. You're providing a way for smaller investors to get into that by securitizing individual art works.

Are there also other securitization mechanisms? What else is going on in the industry, if anything? Is there an art investment trust like there's a real estate investment trust? Or is what you're doing kind of the only game in town?

Scott: Yeah, it's really, really, really fascinating. Again, we were the first company ever to securitize a painting. It's an asset class that historically has never been securitized for whatever reason.

And then (I talk about it a lot), but it must be the largest asset class that isn't securitized, at roughly $1.7 trillion. So whatever the reason for that is, I don't know. I'm somewhat – I share your opinion, which is it's surprising that it hasn't happened. But we really are the first ones to do it.

Erik: Now, Scott, I'm guessing that this is only available (similar to a hedge fund) to accredited investors, at least in the United States. Is that correct?

Scott: It's actually not correct. We went through a lot of effort to make sure that these are SEC-qualified offerings, which allows any investor to invest in them. And that's also a core reason that our trading markets work is that anyone can buy and trade shares in these securities. So it really is open to everyone.

Erik: Okay, so this is open to both accredited and non-accredited investors. How's it going? It sounds like, to my surprise, you're really the only guys in town that are doing a securitized model on fine art.

So is this something that just a handful of art experts are investing in? Or are you getting more popular interest than that?

Scott: As you can imagine, since this is the very first time for investors to really gain exposure to this asset class, we've had just a huge amount of interest. We are setting up nearly 1,000 investors a day now. Some of our smaller offering that are around $1 million dollar paintings are selling out in 24-48 hours. So there really has been great reception across the board.

Erik: Scott, in closing, I've got to ask the hard question which is it seems to me like everything you're describing here sounds great if you guys are competent and know what you're doing.

Now, I know you've been in the art world for more than 20 years. You've got a team of people who do this. Are the qualifications and experience of that team documented some place? Because, frankly, if I were an investor considering this, I'd want to know what your degree of experience and knowledge in the art world is, because I know I don't have it.

Scott: Of course, everyone can come to our website at www.masterworks.io and read about the team. And also we publish a large amount of research from our research team on the art market.

And I'm obviously biased, but I do think our research team is kind of the leading research team in the art market to understand returns and correlation, which really is what any sophisticated investor cares about. So, again, everyone should just come to www.masterworks.io to learn more about the team and our research.

Erik: And I believe they can also find the past deals that you've done, how much the paintings cost, and what the painting looks like, and who the artist is. That stuff is all on the website, isn't it?

Scott: That's on the website.

Erik: Fantastic. Well, I can't thank you enough for a terrific interview. This is an asset class that I admittedly don't know anything about myself.

But it doesn't take much to watch the news and see that a lot of the major fund managers are investing in fine art as they continue to look to diversify away from the financial system into hard assets. So it's absolutely fascinating.

Thanks so much for your time, Scott. For the MacroVoices podcast network, I'm Erik Townsend.