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Is small really beautiful? The mixed case for art tokenisation

To open up art investment to all investors, investing in art aggregates, be they portfolios, funds or even indices, would make more sense than art tokens.

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WHEN in 1904, a group of French collectors decided to create an art syndicate to collect works of then contemporary and upcoming artists (including Matisse and Picasso), little did they know that they were paving the way for art investment. The syndicate known as "the skin of the bear" adopted a simple buy-and-hold strategy, by betting on price appreciation. Over time, 145 paintings and drawings were purchased and eventually sold in a landmark auction held in Paris in 1914 for an estimated gross annual return of 15 per cent.

The concept of art investment gained institutional recognition when in the 1970s, the British Railways Pension Fund which was concerned with the risk of galloping inflation at the time decided to invest in a diversified portfolio of artworks as part of its overall investment strategy.

Art tokenisation as the latest incarnation of art investment

The latest incarnation of art investment is art tokenisation, a process underpinned by blockchains. Art tokenisation essentially combines fractionalisation and securitisation whereby ownership of an artwork is

transferred to token holders who each own part of the artwork, be it a painting, a sculpture or any other art forms. Tokenised assets are selected among works submitted by their owners - private collectors or art galleries - to the platform management. Once tokenised, they are classically held in safe storage facilities waiting in optimal conservation conditions to be offered for sale again at the most opportune time, which might range anywhere between three and 10 years.

A few specialised fine art investment platforms enabling tokenisation have sprung up in recent years. In addition to art tokens, these platforms offer a range of innovative art-related investment solutions, including over-the-counter blockchain-powered so-called "art derivatives" which are essentially peer-to-peer smart contracts encapsulating wagers on the outcomes of future fine art sales held by leading auction houses.

Art tokenisation is part of a broader trend towards real asset fractionalisation in decentralised marketplaces powered by Distributed Ledger Technology. Artworks provide a seemingly ideal substrate for tokenisation due to their lumpiness and trading on illiquid markets whose inefficiency results in hefty transaction costs for market participants. Tokenisation promises to make the art market more transparent and liquid for the benefit of all investors, not only large players.

Beyond the concept's marketing friendliness, what value does the fractionalisation of highly heterogeneous assets such as artworks actually add to investors? Indeed, single artwork tokenisation comes with many unanswered questions.

Where will tokenised artworks come from?

Artworks to be tokenised are selected by platforms' managers among those offered by collectors or gallery owners based on criteria including potential for capital appreciation, provenance and other fundamentals. Some platforms specify that tokenised artworks are exclusively blue chip artworks whose value should exceed a certain amount, for example US$1 million. In a market that thrives on confidentiality, tokenising an artwork seems like a very public proposition.

Why would collectors or gallery owners decide to let go their best artworks in such a way unless they have better use for their capital (for example, other artworks to purchase)?

Small investors are not art experts, nor are they exposed to the type of insider knowledge that would enable them to differentiate between great artworks and others. In that respect, there is clearly a risk that tokenisation can be used for recycling capital on not so great artworks by targeting non-informed investors. A

related issue is that of scalability of art tokenisation platforms. Where will "tokenised masterpieces", necessary to fuel an active market for art tokens, come from over time?

This is all the more concerning as a poll conducted by Deloitte Art and Finance in its 2019 annual survey of the art market shows that only 19 per cent of collectors and art professionals surveyed would be interested in participating in art tokenisation.

How to value tokenised artworks?

Another fundamental issue of art investment platforms stems from valuation that affects the pricing of art tokens. To create a liquid market for art tokens, there is a need for regular valuation of tokenised artworks. In a nutshell, three methods are customarily applied to value real assets: the income approach, the cost approach or the sales comparison approach.

In the case of fine art tokens, only the sales comparison approach may be used, as artworks held in storage intrinsically yield no revenues, notwithstanding their cost of carry. An asset whose only source of return stems from price appreciation is by definition more speculative than an asset whose returns involve periodic stable cash flows, for instance rents, as is the case of commercial real estate.

Artworks' truthful appraisal is therefore crucial to the workings of an art tokens market. In most platforms, token holders are supposed to accept valuations determined by these platforms' management teams. For good measure, internal valuations might be cross-checked with third-party experts' appraisals. But, what would be the management's willingness to mark down a tokenised artwork it has been instrumental in selecting? Subliminally, art tokenisation platforms seem to be the by-product of a bullish art market where fortunes can only be made, and never lost.

However, unless proper governance rules are in place, a faulty valuation process could potentially undermine investors' confidence in the fledging market for art tokens. This would not be the first time that lack of transparency in the price discovery mechanism dooms a new innovative market. Realistically, given the opaqueness of tokenised artworks' valuation process, it seems premature to claim that art tokenisation fosters the art market's efficiency.

Do art tokens allow for diversification in multi-asset portfolios?

One can hardly equate tokens on single artworks to commodities, let alone financial assets, inasmuch as each artwork is quintessentially unique. Do these tokens make good diversifiers in multi-asset portfolios? It is basically impossible

to tell as investing in a single artwork is closer to a very idiosyncratic bet than to modern portfolio theory.

A market too big to ignore

Deloitte Art and Finance assesses that the art and collectible wealth held by ultra-high net worth individuals will reach US$2.215 trillion in 2023, of which US$455 billion will come from Asia. To tap this source of wealth, a better use of tokenisation could be to fractionalise portfolios of artworks, for instance by bringing liquidity to art investment funds.

Investing in art aggregates, be they portfolios, funds or even indices, would indeed make more sense than art tokens in view of opening up art investment to all investors. In that respect, a digital version of the 1904 "Skin of the Bear" art syndicate would be more sustainable than breaking masterpieces into pieces.

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