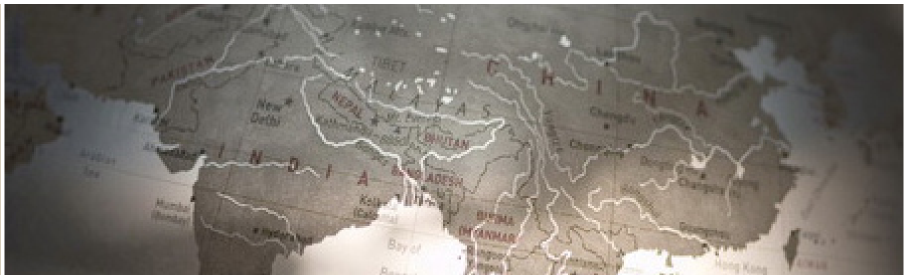
FINE ART
WEALTH MANAGEMENT



ART FUND Tracker

ISSUE 1
PUBLISHED NOVEMBER 2008

WELCOME

Randall Willette,
Managing Director
Fine Art Wealth Management Ltd

Welcome to the inaugural issue of Art Fund Tracker from Fine Art Wealth Management (FAWM).

As interest in art as an alternative asset class has grown in recent years so has the emergence of art investment funds. FAWM first began studying art funds back in 2003 to fill the void in the useful information available around art funds for wealth managers and their private clients. Today we estimate there are over 50 art funds globally at various stages of development. More art funds are concentrated in India than any other country in the world followed closely by Europe, U.S., Asia and the Middle East.

Art Fund Tracker is the first publication to provide coverage of the art fund market providing information on global developments, analysis of regulatory issues, new art fund launches and interviews with the people behind them.

In our efforts to actively maintain coverage of art funds globally, we are seeing two distinct investment strategies emerging; one a sector allocation strategy and the other more opportunistic. The first strategy is designed to emulate the world's top collectors who tend to focus on specific sectors of the broader art market. Those funds pursuing a sector allocation strategy seek to obtain their investment objective of medium to long term capital appreciation through the active management of a broadly diversified portfolio of art across the most established sectors.

The second strategy translates the activities of the world's leading art dealers and auction houses by identifying opportunistic financial transactions and direct investments that can result in superior shorter-term returns. Funds that pursue an opportunity strategy replicate the activity of, and in some cases partner with this accomplished group of art professionals to pursue investments across a range of regional and niche opportunities. Moreover, these funds make strategic investments in collections or portfolios of new works, which can be resold through traditional art market channels. Works may be purchased either for long-term capital appreciation or short term arbitrage and include contemporary art works from China, India, Middle East and Latin America as well as photography and collectibles. Transactions include trading opportunities to buy and sell works quickly to achieve an immediate return, as well financing opportunities and equity participations with significant upside potential.

Equally important in the evolution of art funds, we are seeing them being actively managed globally across three key dimensions including: opportunity, value and risk. A critical element to the success of any fund that invests in this unique asset is its ability to find attractive investment opportunities on favourable terms. Proprietary deal flow remains an important consideration for investors selecting an art investment manager and the ability to receive "first call" on unique and attractive supply through strategic market positioning is a major competitive advantage. For most art funds this is achieved by leveraging expertise across a deep network of international art experts to identify targeted opportunities. In addition, opportunity can be further managed through the use of economic and behavioral research and the market intelligence of the management team. Anomalies in pricing, market trends and economic data can reflect certain regional and sector opportunities and those funds that are most effective in managing this will stand out from all the others. FAWM believes that there is a direct relationship between the inefficiency of a market and the value of expertise and this is particularly the case in the highly competitive art fund market.

Similar to a private equity manager an art fund manager must not only engage

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WELCOME

time and the right price but also to enhance the value of each individual asset it manages. In our review of art funds globally, we have found that most art funds intend to achieve this through a variety of curatorial and marketing activities commonly practiced by successful collectors and dealers.

Finally, and most important, investments in art as in other investments involves substantial risk of loss. Art funds must be able to manage the risks within their portfolio on several levels. Economic developments and market trends that could impact future buying or selling behavior must be constantly analysed and reviewed. Also, wherever possible, funds should seek to employ a non-concentration strategy to mitigate risk of exposure to a single opportunity. Equally important, the fund must be keenly familiar with the risks associated with the purchase of individual works, including questions of authenticity, title, condition, and provenance. This can only be achieved through the expertise, market intelligence and depth of experience of the management team.

Given the illiquid nature of art funds and their dependence on other aspects of the economy, it is not assured that a fund will be able to dispose of its investment at the times or on the terms it desires.

In effect, those art funds which will be the most successful are those that have built an internal team and formed exclusive partnerships with dealers, curators, economists, art sector experts and investment specialists supported by quantitative and qualitative research to derive unique art market insights.

We hope the publication will become an invaluable source of information for those wishing to be kept up to date with the latest developments in this fast moving industry.

INTERVIEW
Neville Tuli

Founder and Chairman of Osian's Connoisseurs of Art Private Ltd

In the first in a series of interviews to be conducted for Art Fund Tracker, Randall Willette interviews Neville Tuli, the founder of one of the most pioneering art and cultural institutions in India with business interests including a leading auction house, wealth management services for art, and a major film archive.

RW: Neville, why did you decide to launch the India Asia Arab Art Fund?

NT: Osian's is first and foremost a unique private sector infrastructure-building cultural institution whose single minded aim is to help place the arts and culture at the heart of India's developmental framework. In this context all our divisions from the auction house to the archive, from the museum to the publishing and design house, from the football team to the art advisory services, are working towards this common goal. Art Funds are a pivotal platform which takes forward a few aspects of this vision. It (an art fund) comes into existence because of the expertise built up as a result of fulfilling the larger vision. Without this larger & deeper context and expertise the running of a world class art fund is in my view very difficult and fraught with various risks.

However, the IAAAF has emerged as a result of the international plans I have had for the past two years. Osian's is only an Advisor to the IAAAF. A whole new institutional framework has been built internationally so as to empower the fund and lease out all the past expertise and knowledge-bases in a systematic manner. The Art Fund is a step in the larger international infrastructure-building program one has in mind.

RW: As one of the newest art investment funds to enter the market what most distinguishes the IAAAF from the other art funds out there?

NT: Naturally, the larger vision as mentioned earlier leads to a uniquely diversified yet integrated knowledge-base, ethos and sensibility. An ethos rooted in creating wealth for others first and foremost, enjoying that responsibility, having an attitude rooted in sharing and disseminating knowledge & financial databases, leads to a rare concept of transparency and documentation. Naturally the experience of Osian's having built and owning the world's largest archive-cum-library on the Indian and Asian Arts and Culture is a very significant advantage. The sheer range and scope of the IAAAF (hence transforming the risk-reward profile), spanning so many geographical regions, time periods and genres of art is unique because of this vast-knowledge-base which purely financial driven institutions or art galleries cannot begin to undertake or aspire to replicate. We recognize that the conflict of interests is the very source of the expertise and the strength which allows an art fund to be managed successfully with integrity and knowledge. This is not a subject you can cut up into rigid detachment compartments for governance. A different, more deeper, transparency is required, rooted in an ethos.
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INTERVIEW
NEVILLE TULI

RW: Can you briefly describe the structure of the fund?

NT: It is a 4 year lock-in closed-ended privately placed Cayman Islands registered fund with a Jersey Feeder, with the first closing on 25th October 2008 and the final closing on 25th January 2009. The Board of Directors for the Fund and the Management Company are responsible for all decision making and governance issues. The Art Inventory Management responsibilities are handled by Osian's International LLC from Dubai and London. Osian's (India) provides non-binding advice through monthly reports on all aspects of the art markets. The Administrator, Ogier, is based in London, with KPMG acting as the External Auditors.

RW: It is clear from the name of the fund which geographies you have chosen to invest in. Why have you selected these particular geographies?

NT: Each geographical art market chosen is at a different level of growth and infrastructural development, thus giving rise to different opportunities over the next five years and creating a very well diversified framework so as to minimize the risk-reward profile, lending even greater consistency to the already stable asset of art. Further, each market and art type chosen (e.g. modern and contemporary to antiquities) provides a different level and degree of liquidity and level of public awareness hence allowing a further layer of diversification with the geographical range. For example, today select Indian modern masters are relatively liquid and stable, with a strong domestic market, appreciating 18 to 24% p.a. while high quality Indian antiquities are less liquid, without a strong domestic market, but with greater critical acclaim, and appreciating at 26 to 35% p.a, while antiquarian books on India, has the strongest growth but the smallest market, and the most nascent domestic infrastructure but the best international dealer network, and so on. Each complements the next.

RW: What is the target size of the fund? How close would you say are you to achieving this?

NT: US$200 million. We will exceed the target.

RW: I understand the fund resembles a private equity fund model in that your investment strategy will be medium and long term capital appreciation through active management of the assets in the fund. Is this correct, and if so what do you expect to be the average holding period and what kind of returns do you hope to achieve for investors?

NT: Unlike any other fund manager we are very keen to provide both income distribution through dividends along with a medium tem capital appreciation. Once this dual responsibility can be managed effectively and consistently the very concept of art as a credible asset and investment will be redefined in the minds of the financial institutions and HNWs. Naturally this is not a straight forward option but it is something with which I have experience and some minor success. Thus we are looking to art assets to be held for 18 to 30 month duration. Given the nature of the art asset, its opportunity cost in the minds of investors, and the nascent stage of liquidity and the infrastructure, most investors would be expecting a net return of between 16 to 24% p.a. in a very consistent manner.

RW: I understand that you will have a number of different interests in relation to the fund including acting as a Director of the Fund, Investment Manager, Advisor and Inventory Manager. Do you not see any potential conflicts of interest? If so, how do you intend to address these?

NT: The very nature of any expertise, not just in the art and cultural sphere, has to have conflict of interests at its heart. The only sustainable answer to resolving any conflict of interest issue is transparency at the highest levels of due diligence but without destroying or compromising the expertise. Today the financial systems are facing many problems because in the name of resolving conflicts of interest they create these so-called independent committees and boards with third parties and in the process undermine the expertise, thus creating a far greater danger and negating the very reasons to invest in that area. Many of the so-called Chinese walls are facades which appease the technical aspects of corporate governance but undermine the very spirit that corporate governance was introduced to follow. I have functioned with a plentitude of conflict of interests for over fifteen years at the highest level of public scrutiny, and the only true way such can be resolved is by being transparent in all the documentation you produce. Some will always mistrust you irrespective of facts, the key is to live up on a daily basis to those who place trust in you. It is not always easy and transparency alone allows the journey to be sustained with integrity.

RE: I also understand you have assembled quite a prestigious team of experts and board members. Can you briefly explain the experience they bring to the fund?
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GLOBAL FUND NEWS

The value of expertise in art investment funds

Philip Hoffman,
CEO of The Fine Art Fund Group
www.thefineartfund.com

The attraction of art as an investment is that fine art provides an opportunity for portfolio diversification into an area that has historically provided high returns. The art market, over the long term, has proven to be a very stable investment with a very positive history. Even though the idea of making a profit out of art is a very old one, over the last decades art has gradually developed into a new asset class. Art funds are simply the vehicles that take advantage of this market, with the aim of providing long-term capital growth for high net worth individuals who wish to diversify their risk and do not have the experience to buy and sell art for themselves.

The Fine Art Fund Group, which launched its first art fund in 2003, has now grown to have five different funds under management, spanning Western Art, Chinese Art, Middle Eastern Art, and Indian art. The Fund started investing, with a core team of experts, in Western Art (Old Master paintings, Impressionist, Modern and Contemporary Art), at a point when the market was on the rise, and has since expanded into the more 'emerging art markets'. Across its different funds, the Group aims to provide annualized returns between 10-15% on investors' initial investments. Based on third party valuations the Fund has outperformed these figure estimates. The Fine Art Fund, which is now closed for investment, shows an average annualized rate of return of 38% and an IRR on assets sold of 30%.

In the art world, you are only as strong as your reputation, your contacts and your information, whether this is with auction houses, art dealers, art collectors, or museum curators. As an art investment vehicle, we endeavour to have relationships all over the world, with each of the aforementioned groups, in order to really know what is happening in each area in which we invest. Without specialised advice, one should not take the risk, whether as an investor or a collector.

However, at this point, it is necessary to mention that there is an inherent difference between art investing and art collecting. We would say that the keys to success in investing in art include the need for agility and cash in hand to seize opportunities; reliance on experts; as well as a critical awareness of the impact of changing tastes. If you have an excellent team of experts, are sitting on a lot of cash and are prepared to hold art over a five to ten-year period, you can make substantial profits, but again this must be carefully overseen. Above all, when acting as an investor, you should not be emotional towards the art, which is the opposite to how a collector should think.

The Fine Art Fund Group's team is of a strong global nature, and we try to work with the best experts in each sector, in order to receive a strong picture of what is happening in each individual market. The Group is comprised of a strong team of more than 30 professionals in ten different countries. As such, art market knowledge and access to off-market deals allows for significant arbitrage opportunities. By using the information asymmetries within the market to our advantage we manage to minimize the transaction costs usually associated with buying and selling art, something which individuals might find hard to do. The Group has brought together some of the world's leading experts in fine art who have extensive knowledge of the market and of advising leading collectors and institutions.

The Art Buyers and Art Advisors all have well over fifteen years' experience in the sections of the market in which they specialize. The agreements we have with them have been structured to align their interest and those of the investors, by granting a long-term profit incentive to the Art Buyers and Art Advisors to give The Group the full benefit of their market intelligence. The Art Buyers may not offer their own stock to The Group nor offer works of art in which they have financial interest without informing the Manager in advance. In such cases a different strategy is followed. Our decision making process is designed to rule out possible conflicts of interest.

Confidentiality should also be one of the core values of an art investment fund. We are cautious with our purchases and sales and everything is done confidentially. We do not strategically promote the art we buy, nor do we disclose any information, in order to protect our clients and strategy. We are very selective in what we buy and sell, and are overtly careful in how we invest especially since some of our investors

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ART FUND Tracker

ISSUE 1

PUBLISHED NOVEMBER 2008

GLOBAL FUND NEWS

Capitalizing On The Emerging Art Market Opportunity

Andrew Littlejohn

MANAGING PARTNER

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Recession; Credit Crunch; Mortgage Meltdown; Bank Failures; Government Bailouts: this dire outlook has driven the Western financial markets into oblivion and has all but paralyzed the global capital markets. The world has lost confidence in the Western financial system and the paper assets, which provide the major source of investment options for investors. As such, there remain few viable investment options structured on the traditional asset classes.

There is a silver lining to this very dark economic cloud hanging over the world, in the form of a few niche opportunities where one may make money despite what is going on in the broader capital markets. On 15 September 2008, the same day that saw the collapse of, effectively, two of the world's largest banks [Lehmann Brothers filing for Chapter 11 bankruptcy protection and Merrill Lynch being bought in a distressed sale by Bank of America], the art market showed its resolve and its disinterest in the capital markets' failures. On this evening—which many naysayers predicted would be a disaster—Sotheby's London brought down the hammer on the first part of a two-day Damien Hirst sale, totaling over £70 million against an estimate of £65 to £98 million (for the entire two-day sale). The following day, as the world learned of another major financial firm's failure [American International Group], the second part of the Hirst sale totaled £41 million, bringing the two-day total to £111.5 million. The reasons why this sale was so successful are manifold. However, indications from inside the market have pointed to many of the top bidders coming from Asia, the Middle East, Russia and other emerging markets, as they have been at all the major contemporary art sales in London, New York, Hong Kong and Dubai over the past two years.

Over the past six weeks, since the initial bank failures and the resoundingly successful Damien Hirst sale, the art market has tempered a bit with less than stellar London contemporary art sales at Sotheby's, Christie's and Phillips de Pury during the annual Frieze art fair week. However, despite many mid-quality Western lots failing to sell, contemporary art from emerging art markets performed quite well, with most of the best works selling within estimate and a few above the high estimates.

I am wholly convinced that investment grade fine art is the single most attractive investment opportunity in any market, but especially in today's turgid economic environment. The emerging markets continue to mature and a larger correction in the "blue chip" Western art market will produce significant arbitrage opportunities for those sitting on cash.

So, why is art such a particularly alluring asset class? In addition to possessing all the positive attributes of other real asset classes (i.e. high residual value; inflation proofing; low volatility; and, low/negative correlation with traditional asset classes), art possesses numerous unique qualities, which make it a highly effective alpha generator.

First, empirical research conducted over the past several years, using the Sharpe Ratio, has demonstrated that the addition of art to an otherwise conventional portfolio can increase the overall return without any corresponding risk. The results of the calculations have led certain wealth management professionals to recommend allocations of around ten percent to art as part of a diversified portfolio allocation strategy.

Second, the art market is extremely inefficient, opaque, and it is controlled by a relatively few influential players. It is also the last unregulated market of scale in the world. Quite simply, if one is not part of the market's inner circle (and it takes time or significant amounts of money, and often both, to become part of this), one will not be able to participate at the most lucrative levels. All wise investors know that with inefficiency, opacity and lack of regulation, there exists significant opportunity for financial gain.

Those relatively few influential players who are well-connected, such an art investment fund with a team of the world's best art advisors, have the ability to access the very best work, at the most attractive price points and, subsequently, are able to sell relatively easily at the most opportune times (read: liquidity) for a substantial profit. Of course simply buying and selling for profit over a short period—flipping—will not make one many friends in the

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GLOBAL FUND NEWS

Capitalizing On The Emerging Art Market Opportunity

art trade. The art market is very closely held, and any serious player must abide by unwritten rules that always include—at least in the realm of contemporary art, which includes artwork created by living or recently dead artists—supporting what is in the best interest of the artist's career.

The importance of market access cannot be understated. Every artwork is unique and, therefore, possesses at least some semblance of rarity. As such, there often is a situation where the market demonstrates extreme inelasticity, meaning demand far outstrips supply and the amount people may be willing to pay to obtain a work seems to have no limit. In the contemporary art market, in which primary market galleries vehemently protect and support the careers of their artists, one's ability to obtain the very best artwork—no matter how much one may be willing to pay—is severely limited unless one's reputation is well known.

Third, both static and variable qualitative aspects determine the value of an individual artwork. Static aspects affecting value include: artist; country of origin; subject; size; quality; medium; resonance; and, rarity. Variable aspects include: critical literature pertaining to the artwork/artist; exhibition history; commercial gallery support; prominent collectors or institutions owning similar artworks; circumstance; fashion; and, freshness to the market. With the former (static), value selection is of significant importance, and all the aforementioned aspects must be evaluated fully to determine an accurate value. With the latter (variable), one can do much to manipulate these aspects to the benefit of the artist/artwork. We at Meridian Art Partners like to call this value creation or active management. If one is able to augment positively the perception of a certain artist and/or artwork and influence broader market recognition, market value inevitably will increase. And, the beauty of such value creation is that it is completely legal and even applauded, given that everyone involved stands to benefit—investors, other collectors of the artist/similar artwork, the representative gallery and, of course, the artist.

Bolstering the art investment argument even more is to place it in the context of the global emerging art markets opportunity. Over the past five years, the art market has become undeniably global. There are numerous drivers of this phenomenon; however, the most prominent is new wealth creation in the global emerging markets. As the wealthy constituents of these nations (throughout Asia, Latin America, Africa, the Middle East and Eastern Europe) become wealthier, they increasingly focus their "passion investments" on the art market, despite what has been going on the Western economy. The Capgemini Merrill Lynch World Wealth Report 2008, reported that, in 2007, investment in fine art represented 15.9% of discretionary income spent on passion investments by the world's High New Worth (HNW) population. This average contemplates 21% in Latin America; 13% in Asia Pacific; and, 10% in the Middle East.

This data represents only the tip of the iceberg; in fact, the level of art market interest and activity in the emerging markets is quite more remarkable. Interest and investment in the art market, particularly contemporary art, by HNW constituents of newly wealthy nations has lead to the development of critical national and regional art market infrastructures which, in turn, will lead to the long-term prospering of these emerging art markets. London and New York still remain the centers of the international art market, and they forever will be important in solidifying international acclaim and price stability. However, the most fascinating activity is now taking place in places such as Jakarta, Singapore, Beijing, Dubai, Tehran, Delhi, Johannesburg, Moscow, Mexico City and Sao Paolo.

It is a proven fact that the substantially wealthy in these emerging markets have a significant sense of national pride, and this is manifested in their support of their national (and regional) art markets. New museums are being built at a furious pace to showcase the best contemporary art from these emerging art markets; foundations are being set up monthly to fund artistic development; robust commercial gallery scenes are prospering on the heels of increased collector interest; new art biennials and fairs are recognizing the best new talent; there exists serious critical review in dedicated art market publications; and, regional art auction houses provide venues for increased market activity and confirmation of market value.

What does all this new activity mean? It is simple: these critical infrastructures on the national/regional level create viable art markets which support and build up the reputations of these areas' best artists and, consequently, propel them onto an international stage where they are able to be recognized by an even larger base of critics, institutions, influential curators and galleries, not to mention eager buyers. The emerging art markets of China, India and Russia have already demonstrated
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GLOBAL FUND NEWS

Primary Art Market Investments – A Safe Haven When All Else Suddenly Correlates?

Manuel Gerber
PhD MSc MA
CEO, Prime Art Management Ltd.

Amid fears of an imminent art market collapse fuelled by weak sales at both auctions and art fairs, the primary market for emerging art is fast becoming a minefield for both casual investors and investment vehicles that depend on the volatile secondary market as their only resale channel. However, there is one type of gallery that remained largely unaffected by the last art market crash and is well-positioned to survive the current one unscathed. Provided the secondary market can be by-passed, these galleries can indeed function as a safe haven for art investors in a progressively uncertain environment

What makes a gallery a good or bad bet in the current market climate?

For several years, emerging art meant easy money. Due to the influx of vast new segments of mostly undiscriminating buyers even works by young artists with little or no potential to ever attain lasting relevance could be resold at high gross gains after very short holding periods.

This development not only boosted global auction market turnovers, but also fuelled the proliferation of art fairs and directly caused their emergence as by far the most important source of artworks by young artists appearing at auctions for the first time . Many of these artists were represented by a new breed of young galleries that focus their sales efforts almost exclusively on art fairs and, as a consequence, on an anonymous buyer pool. Placement, for them, is irrelevant.

To illustrate the prevalence of this phenomenon among young galleries: More than half of the under-six-years-old galleries examined by Prime Art Management Ltd. as potential suppliers to our fund cluster at the extreme end of this category with at least 80% of their annual turnovers achieved at fairs. We have rejected all of them since the start of our project in 2007 despite many of them being perceived, up until a few weeks ago, as potential heavyweight players in the future. They do not qualify because they violate two sine qua non predictors for long-term gallery success: the presence of a local pool of loyal sophisticated buyers as well as a strong commitment to the strategic placement of artworks in specific collections. “Good” galleries, by our definition, sell works they consider important only to people or institutions they consider appropriate buyers. Very often at the expense of near-term cashflows because the more courageous and ahead of their time these galleries are, the longer it takes them to build a sufficiently large pool of sophisticated buyers to absorb the output of their artist stables.

The typical buyer of the rejected group, in contrast, does not live in the same country as the gallery, has been collecting art for no more than three years, and remains anonymous in the sense that a personal relationship between the gallerist and the buyer is not considered a prerequisite for a deal by either party - whoever pays the right price gets the work. This buyer type considers art as an investment and concentrates on works that are reminiscent of whatever exhibits the greatest momentum in the secondary market: in recent years this usually meant flashy, technically flawless pop with an exotic flavour that is aesthetically and conceptually easy to digest.

With very few exceptions these galleries are now being hit as severely by the financial crisis as their buyers. Consolidation is imminent and uncritically buying into their portfolios of artists via auctions now that secondary market prices are dropping far below gallery price levels is likely to be a bad bet, as this particular pocket of the art market is lacking the fundamentals to recover in its current form in the next art market upswing: The success of the fairs-centred business model is so directly linked to a booming secondary art market that a prolonged weakness will cause many of its exponents to disappear from the scene for good and the art they represented to become unsellable.

When things get rough, a gallery is only as good as its buyers.

Since the 1960ties, first-time sales of works by artists that have achieved lasting relevance in the world of contemporary art have invariably been controlled by a different type of galleries. The common characteristic within this otherwise very heterogeneous group is an extreme selectiveness regarding who they sell to.
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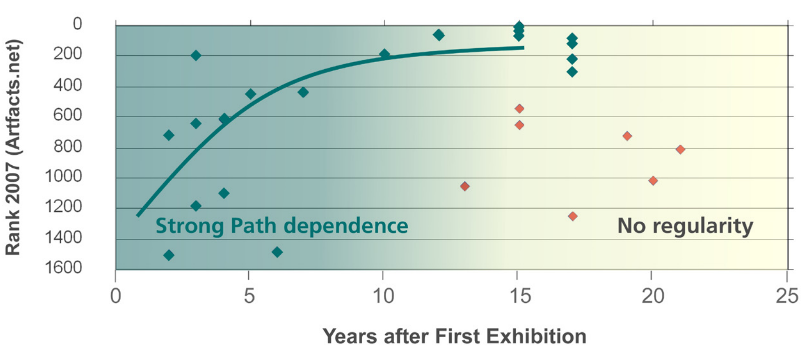
Primary Art Market Investments – A Safe Haven When All Else Suddenly Correlates?

Why is this relevant? The aggregate status of a gallery's pool of loyal buyers and previous successes within its artist stable compensate collectors of emerging art for the fact that the artists they are interested in lack a verifiable track record, i.e. auction sales. A fair-focussed gallery cannot offer this type of security.

Information about young artists at the very beginning of their career being inaccessible from outside these small and isolated gallery-collector loops, the relationship between galleries and buyers of emerging art is by its nature very direct and, in the case of young galleries, usually geographically local. As a result, the primary market for high-quality early-stage art is highly fragmented and its economics remain ill-understood.

This trust-based system of mutual endorsement by galleries and collectors is self-reinforcing, resulting in a strong path-dependence of the future success of an evolving gallery stable as a whole on early successes of individual artists within that stable (Fig.1).

Fig.1: Path-dependence of gallery portfolio development after initial successes.



Sample Gallery, Switzerland

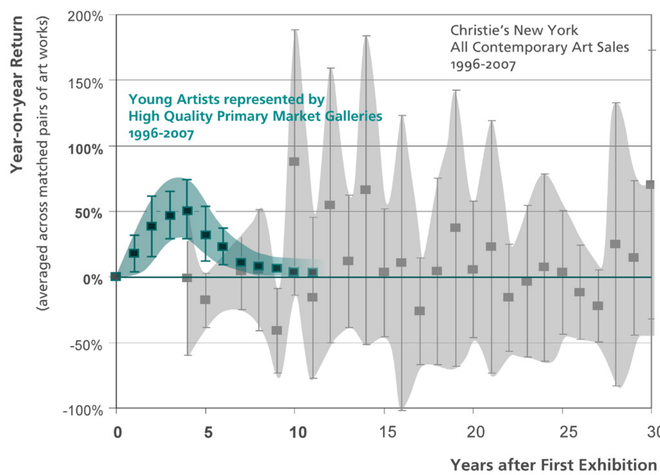
n = 26 artists
Proxy for career progress: rank

Path dependence:
First major successes: 17 yrs ago
Onset: 15 yrs ago
Outliers after onset: 1

On a local level, private investors with the stamina and will to build a serious collection of emerging art will over time gain access to enough information to spot such galleries early and benefit from their above-average long term potential by entering their collector pools. At a global scale, our company, having exclusive access to a growing number of detailed gallery sales datasets across different geographies, is probably the only entity currently able to identify, monitor and understand such local developments as well as their drivers econometrically.

Within the group of galleries qualifying for partnership by our criteria, prices paid at the supplier-collector interface (Fig. 2; green; indicated are means +/- 1 STD) follow a highly regular and, therefore, predictable pattern of price appreciation. Annual price increases are greatest in the first four to five years after an artist's first exhibition and then slowly adapt to the levels achieved on average in the secondary market (Fig. 2; grey). These early price increases are scripted, not directly demand/supply-driven , and far more pronounced than any that can be identified with a similar degree of predictability at later points in an artistic career. However, these are pure acquisition prices and can therefore not be replicated in resales by the average collector. In Fig. 2, the lagged onset of secondary market trades illustrates this point nicely: in years 4-9, resales are likely to re

Fig. 2: Year-on-year price developments for young artists in the primary and secondary markets.



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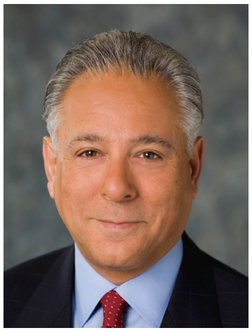
Emerging Liabilities in Managing and Investing in Art Funds



Lawrence M. Shindell, J.D,
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www.aris-corporation.com

Record art prices have ushered in the return of art investment funds to the global art market. Recent international economic turmoil has further heightened attention to art as a strategic investment. Conspicuously absent from discussions about art investment funds, however, is the fact that a fund's total loss of even a single artwork or a partial monetary loss due to settlement or litigation costs because of defective legal title to the artwork will almost certainly significantly diminish the fund's returns for many years. Most art funds publicly expose their artworks through publication or exhibition to enhance the value of the artworks and increase fund returns. Ironically, this exposure often engenders an art title claim because it may be the first time in years that the location or current owner of the work is publicized and becomes known to potential claimants or professional plaintiff attorneys. Today's claimants include contemporary art dealers and artists who hold contractual rights-of-first-refusal on primary market works circulating in the secondary market, e.g., *Flower Ball Blood (3-D) V*, 2007, by Takashi Murakami, which was pulled at the eleventh hour from auction at Christie's London in June 2008 and is now the subject of litigation in a Tokyo district court.

The art market (now exceeding $50B in annual sales) is the largest lawful industry in the world that is essentially unregulated. The resulting lack of transactional transparency and in turn the risks of defective legal title (ownership) stem from the long-standing art industry practice of withholding seller and buyer identities to protect their privacy as well as dealer sources and pricing. Steven Spielberg, a well-known Norman Rockwell collector, unexpectedly faced head-on the problem of art title risks when in 2007, decades after he purchased in good faith Rockwell's *Russian Schoolroom*, the FBI reclaimed the painting, which had been stolen thirty-five years earlier.

Art market dynamics are such that art buyers (even the most sophisticated art investment funds) cannot access critical details about the legal title of works they buy. This void includes the seller's name, the status of prior owners' legal title to the work, whether the selling-dealer actually owns the art or is acting as an agent for an undisclosed principal (creating authority-to-transfer-title issues) and whether intermediate dealers are involved. There is no single repository of public or private records in the art industry to enable a buyer comprehensively to investigate legal title to art, although there is varying anecdotal, sometimes publicly available and often incorrect provenance information (the whereabouts of the work from leaving an artist's studio to the present day). As a consequence, all art transactions pose title risks of differing degrees. The complexity and frequency of these risks are significantly increasing due to financial pressures on art dealers (à la the collapse of Salander-O'Reilly Galleries in the U.S.) and on collectors (facing liquidity exigencies).

Because 75% of all art market transactions are private sales by dealers and galleries (rarely owning what they sell), if an art fund fails to shift the title risks to a third-party insurer, then it must depend entirely on its own ability to negotiate and enforce indemnification from sellers. A self-insurance strategy is problematic because, when a title problem arises as occurred with Steven Spielberg, the fund must be able to locate, serve, sue, obtain and enforce a judgment against the seller at some unknown future date to recover the money it used to buy the art. The seller may be an individual who is no longer alive or a dealer who is located in another country or out of business.

The remaining 25% of art market transactions are auction sales, which pose equally challenging problems because by industry standard auction transactions are subject to the right of the auction house to rescind (without liability) all sales without time or other limitation if questions later arise about the legal title to sold works. Art funds face this risk of rescission and lack of finality to the transaction whenever buying or selling at auction.

Given the fiduciary duty of art investment funds to disclose fully each risk which might affect returns on investment, and given the financial risks inherent in self-insuring against the legal title risks, art investment funds face an inevitable "perfect storm" of art title risk exposure.

Risk Disclosure. Art investment
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LEGAL, TAX AND REGULATORY

The Luxembourg Specialized Investment Fund (SIF)

Jacques Linon and Raphael Glohr,
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From a tax perspective the world of art is often associated with complex, old- fashioned and disparate tax rules, especially in Continental Europe.

Key issues to address for interested individual or corporate investors include amongst other items, capital gain taxation, net wealth tax, VAT (particularly on imports) and succession duties.

Some states provide for a certain exemption of taxable basis or a reduced capital gain tax rate for their residents investing in art. This used to be the case in Luxembourg in the field of net worth tax before such tax was abolished for individuals beginning in 2006. It is difficult to find dedicated tax regimes or tax incentives that are globally attractive for investors interested in art acquisitions.

Some banks have organized in their private banking departments units specialized or covering advice to their clients wishing to acquire pieces of art. Tailor-made solutions can be individually proposed either for direct acquisitions or through more sophisticated trust, foundation or other adhoc financial engineering options.

Luxembourg is well known as an international center for investment funds and private banking and for offering a diversity of investment vehicles to international investors.

Standard Luxembourg companies do not seem to be particularly convenient for a direct holding of art assets, as they will be subject to full taxation at 29.63%[1] on capital gain income. Net worth tax of 0.5% still applies for Luxembourg companies will also represent an additional significant annual tax cost on the value of art assets . The Luxembourg participation [2] regime provides exemptions for dividend and capital gain income subject to specific conditions but this is limited to investment in shareholdings. It could nevertheless constitute an option to hold intermediate corporate vehicles investing in art.

Investing in art through collective investment vehicles (UCI) can represent an interesting and simpler option for many investors provided flexible and tax efficient investment fund vehicles are available in which they could be gathered.

Within investment fund solutions the Luxembourg Specialized Investment Fund (SIF) regime [3] represents a new investment tool option of particular interest for alternative investments such as investment in art and selective investors having a particular knowledge or interest in this field.

SIFs are subject to supervision by the Luxembourg financial supervision body (CSSF) but the regulatory constraints and supervision level is somewhat lighter than for standard funds for the retail market.

SIFs are dedicated to well-informed investors. Pursuant to Article 3 of the law of February 13, 2007, the definition of an experienced investor includes investors meeting the following conditions:

- declaring in writing his adhesion to the status of experienced investor, and

- investing either (i) a minimum of € 125,000 in the SIF; or (ii) obtaining an assessment from a credit establishment [4] , from an investment firm [5], or from a management company [6] , certifying his expertise and his knowledge to appraise in an appropriate manner an investment in a specialized investment fund.

The SIF fund must reach a capital of € 1,250,000 within one year following CSSF approval.

As for any UCI, SICAVs have to comply with the principle of risk diversification in the implementation of its investment policy. CSSF Circular 07/309 provides that a SIF may, in principle, not invest more than 30% of its net assets in a single investment. However, this rule does not apply during the start-up period which may not extend beyond 4 years after the closing date of the initial subscription period.

The SIF can be structured either in the form of a mutual fund without corporate tax form (FCP) or of a SICAV/F having a corporate tax form. A FCP is not a company. Investors are considered to directly own their shares and therefore directly own their share of the assets of the FCP, meaning the tax treatment will depend upon the country of the investors and the country where the SIF invests, and the tax treaties that are in place between them.

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LEGAL, TAX AND REGULATORY

Gibraltar – An EU domicile for specialist Art Funds

Steven Knight,
Director, The Castle Trust Group
www.castletrustgroup.com

A major element in Gibraltar's attraction is that full EU investor protection legislation applies to Gibraltar. It has developed as a domicile for art funds and today is home to 20 banks and around 45 insurance companies backed up by comprehensive legal, accountancy and advisory firms. PWC, KPMG and Deloitte all have strong local offices. On an annual basis, Gibraltar's GDP is currently around 7% and inflation around 2.6%.

Specialist Fund enabling legislation

In 2005 new legislation was introduced for Funds. It is possible to form a Fund which is fully compliant with all EU legislation by using the local Financial Services (Experienced Investor Funds) Regulations 2005. A fast track set up process has been developed whereby locally based fund administrators work closely with lawyers to produce a compliant Private Information Memorandum (PIM). Lawyers independently confirm this fulfils all local, and hence EU obligations, directly to the Gibraltar Financial Services Commission (FSC). The Fund is then eligible to commence operation. The detailed terms and conditions are not onerous. Provided Investors invest a minimum of €100,000, their investment may be accepted by the fund administrator. Alternatively, investors with a net worth of €1 million can invest lesser amounts. The key elements to be included in the PIM will be the parameters of the fund, the business rationale and accompanying risk factors. There is no need to produce detailed financial cash flows and the PIM is not a public document. Confidentiality can therefore be maintained in producing a confidential focussed Fund. Accompanying the Experienced Investor legislation is the ability to utilise Protected Cell Companies. This can mean groups of asset classes or shareholders can be ring-fenced to give maximum flexibility. Traditional umbrella Funds can also be formed. Gibraltar, therefore, is an ideal location to set up an Art Fund as it can cater for many different Investor and investment requirements. Although the Fund Administrator needs to be located in Gibraltar, the Investment Adviser, Manager and Custodian/Depositary does not. They can be located anywhere else in the world.

No tax

Gibraltar utilises the territorial and arising principle in determining liability to taxation. Income which is deemed to derive outside Gibraltar is exempt from assessment to local taxation. This means an Art Fund would receive profits and income gross which would not be reduced by the impact of any local taxation. Further, Gibraltar does not levy any sales or VAT taxes. There are no capital gains or estate duties chargeable in Gibraltar. It therefore offers a completely tax free environment for international Investors.

Swift and cost effective

The combination of the above results in it being possible to set up international trading Funds within a matter of days. The Castle Apollo Fund Limited, a Fund of Art Funds, was set up in less than three weeks. The regulation and practice has now become well defined with over 40 Experienced Investor Funds having been set up. The statutory cost of registering an Experienced Investor Fund is £2,500. Depending upon the sophistication of the structure of the Fund it is possible to set up a bespoke Art Fund for around $100,000 including all legal, fiscal and regulatory costs. There are a number of specialist fund administrators who can cater for the needs of a Fund which usually will have quarterly or six monthly valuations. The absence of a daily dealing requirement helps to ensure ongoing costs are minimised.

Gibraltar presents a powerful argument for the domicile of specialist Art Funds due to its user-friendly short form EU legislation and availability of appropriate professionals to form and run the Fund. This is backed up by a financial centre infrastructure ensuring Funds can be invested from anywhere in the world and repaid at a profit when necessary, as fast as is possible.

Specialist structures for personal wealth planning

For individuals with substantial wealth, the formation and use of family trusts and foundations have long been worthy of consideration. Gibraltar has general Trust legisla-
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ART FUND Tracker

ISSUE 1

PUBLISHED NOVEMBER 2008

LEGAL, TAX AND REGULATORY

Legal and Regulatory Issues to Consider in Setting Up an Art Fund in the UK

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The purpose of this article is to provide an overview of the key legal and regulatory considerations to address on setting up your art fund in the UK.

Do you need to be regulated?

One of the first questions a prospective art fund manager should consider is whether or not he needs to be authorised under the Financial Services & Markets Act 2000 ('FSMA').

This is because under Section 19 of FSMA any person who carries on a regulated activity in the UK must be authorised by the FSA or exempt. Breach of Section 19 is a criminal offence and punishable on indictment by a maximum term of two years imprisonment and/or a fine. This section is known as the 'General Prohibition'.

The second very important section of FSMA for the prospective fund manager to consider is Section 21, which provides that a person must not, in the course of business, communicate an invitation or inducement to engage in investment activity unless he is an authorised person or the content of the communication is approved for the purposes of this section by an authorised person. This section is known as the 'Financial Promotion Prohibition'.

Section 238 of FSMA provides further that, subject to certain exceptions, an authorised person must not communicate an invitation or inducement to participate in a 'Collective Investment Scheme' unless that fund is an authorised unit trust scheme ('AUT'), a scheme constituted by an authorised open-ended investment company ('OEIC'); or a recognised scheme (i.e. broadly speaking, a scheme established in another EU member state or in certain 'designated territories' under equivalent provisions to those applicable to AUT and OEIC). Section 240 prevents an authorised person for the purposes of Section 21 from approving the content of a communication that he would not be able to issue himself.

Accordingly, the prospective art fund manager needs for regulatory purposes early on to identify three things (1) whether the activities he proposes to carry out are regulated; (2) is he interested in making 'financial promotions' and (3) does his fund constitute a 'Collective Investment Scheme' and, if so, is it an authorised unit trust scheme, a scheme constituted by an authorised open-ended investment company; or a recognised scheme.

Turning to the activities first, in the general course of business, promoting and running a fund will involve a range of activities, from distributing the shares or other interests to investors, to managing the assets (i.e. investing/disinvesting) to taking custody of them. Most of these activities will be regulated, save that investing/disinvesting in, or advising on, art works themselves is not regulated under FSMA.

The reason why a fund manager may need to be authorised is that his fund may constitute either a collective investment scheme (a 'CIS') or a Closed-ended Investment Company ('Closed-ended Fund').

A CIS is defined by Section 235 (1) of FSMA as 'any arrangements with respect to property of any description, including money, the purpose or effect of which is to enable persons taking part in the arrangements (whether by becoming owners of the property or otherwise) to participate in or receive profits or income arising from the acquisition, holding, management or disposal of the property or sums paid out of such profits or income'.

There is no restriction on the type of underlying property and arrangements that may constitute a CIS, even if the underlying property itself would not be an investment regulated by FSMA (like art): this point is easily missed. Packaging artwork into a 'fund' thereby imports regulatory considerations previously absent.

The arrangements may include a contract, partnership, a trust or a company or even an understanding or course of conduct. The key point being that 'participants must not have day to day control over the management of the property, whether or not they have the right to be consulted or to give directions.'

This is why you do see a number of private art 'clubs' (generally constituted as general or Limited Liability Partnerships) managing to keep outside of the regulatory ambit, by ensuring that the structure is such that the participants do exercise such day-to-day control. This may be difficult to achieve in practice however, as investors generally prefer to be passive. There are also a number of specific exclusions to the definition of a CIS, which may apply.

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LEGAL, TAX AND REGULATORY

Legal and Regulatory Issues to Consider in Setting Up an Art Fund in the UK

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However, assuming that the prospective fund manager does have a CIS, or indeed a Closed-ended Fund) which is the more usual case.

The effect of this is that units in the CIS (or shares in the Closed-ended Fund) are investments within Article 81 or of the Regulated Activities Order ('RAO') and are therefore investments regulated by FSMA.

The prospective fund manager, in proposing to establish, operate or wind up a CIS, is about to engage in an activity constituting investment business under Article 51 of the RAO, which is an activity requiring authorisation under FSMA.

The prospective fund manager will also engage in certain other categories of investment business contained in the RAO (dealing, arranging deals, custody, managing, advising etc…), which can apply in relation to units of a CIS or shares in Closed-ended Fund.

The prospective manager also needs to consider the promotion of the CIS (or Closed-ended Fund) to investors i.e. the marketing or offering for sale of shares/units. Promoting any CIS (regulated or not) or Closed-ended Funds will virtually inevitably involve the issue of a 'Financial Promotion' (and these can be made in any means whether in writing or orally, and including by email) . Any such financial promotion made in the UK, or it is to have an effect in the UK, will be caught by FSMA. If the manager or distributor is FSA authorised, then, as discussed earlier, unless the CIS is any of an authorised unit trust scheme, a scheme constituted by an authorised open-ended investment company; or a recognised scheme then the prospective fund manager is going to face restrictions on promotion, i.e. the marketing or offering of units in the fund. Broadly speaking, he will only be able to promote the fund within certain restrictions in the FSA: Conduct of Business Source book.

It is highly unlikely that an art fund will fit into any of these categories specified above, because authorised and recognised funds from other jurisdictions are funds which comply with prescribed investment restrictions (largely directed at investment in securities, cash or derivatives) and borrowing limits and these restrictions do not sit well with an art investment strategy. Accordingly, art funds in the main are unauthorised and unregulated in the UK (though some funds invested in collectibles are constituted as closed-ended offshore companies i.e. Close-Ended Funds – and listed on AIM.

The net effect of this is that the prospective fund manager will need to get advice as to his own position re 'regulated activities', as to the regulatory characterisation of his proposed fund and on the content of the materials he makes available to prospective investors during marketing and on subscription.

What structure should you adopt?

The next major question the prospective fund manager needs to consider is the structure of the fund. Two basic questions arise: whether the fund should be open-ended or closed ended and whether the fund should be a partnership or corporate structure.

Open-ended structures are difficult for art funds because the investment strategy doesn't fit well with providing investors with a regular right to redeem.

The partnership or corporate question is primarily a tax one and it would be difficult to provide a tax analysis in the space of this article. However, it is possible to say that many art fund managers favour offshore partnerships, because they generally achieve tax transparency for the investor (depending on his tax residence).

Tax structuring advice at an early stage is also critical for art funds.

Other issues?

Depending on the nature of the underlying assets themselves there will be the usual myriad of legal considerations to navigate relating to points such as due diligence, expatriation, custody, insurance, lending and VAT.

There will also be the need to produce the fund incorporation/establishment documents, offering memorandum i.e. selling document for investors, investment management/advisory agreement, subscription agreement and ancillary documentation.

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INTERVIEW
NEVILLE TULI

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NT: For the board each member brings a different perspective, expertise and perspective, creating a credible and unique source of knowledge, experience and governance. Muthusamy Varadarajan brings over half a century of public service in the highest echelons of the bureaucracy, with the Cultural Ministry being his last official designation with the Government of India. Arif Naqvi brings a brilliant private equity entrepreneurial mind with immense goodwill across the Middle East and beyond. Simon du Pury brings a rare enthusiasm and passion for the arts with years of experience and expertise of the art markets and the auction processes across Europe and the USA. Karan Trehan brings a long standing financial acumen in managing vast amounts of public wealth through funds at the highest international standards. Percy Marchant brings a unique mix of legal expertise, discipline and fund management. Umesh Khimji brings a rare entrepreneurial instinct to create wealth with the eye of an aesthete, and I keep the underbelly strong and the whole directed and cohered.

RW: Who are your target investors? Is the fund open to international investors and if so, are you targeting private or institutional investors?

NT: The private placement is for a very select few, mostly sophisticated institutional investors and HNIs across the globe, especially in Europe, the Middle East and Asia.

RW: What is the term and minimum investment amount?

NT: The term period is four plus the option of an additional one year lock-in with US$200,000 being the minimum investment for each individual shareholder.

RW: You mentioned that your investment strategy is to generate medium and long term capital growth and yet it seems much of current strategy in the contemporary art market is being driven by short term arbitrage opportunities. Would you care to comment?

NT: The contemporary fine arts will be a relatively small proportion of the Fund. We are firm believers that art historical significance is the pivotal parameter in determining the financial valuation of art and changes therein. Thus the short term machinations of the contemporary art market, though interesting and at times rewarding, is not an area we would place any significant amount of principal, client or investor funds, especially with any short term objective (less than three years).

RW: Lately, there has been a great deal of talk that the art market is due for a correction given the current economic climate. Do you agree with this? If so, what sectors do think will be hit the hardest?

NT: The bubble has been bursting for decades if you view with the correct perspective. However, in today's current economic climate, it is the high quality art works which are and will best hold their value, sustain this consistency and stability and once and for all stake its claim to becoming a credible capital asset which can endure the most uncertain and depressive of economic circumstances. As the IAAAF states: 'In times of volatility, the art of stability', it will live these words, and time will irreversibly show how all the major financial institutions of the world finally adopted Alternative Assets with a special focus on the best of the fine arts as a pivotal part of any serious portfolio diversification strategy. Naturally 'poor' quality art will suffer like any other poor financial instrument.

In the end the art funds which have the deepest aesthetic 'eye' with the ethos of a scholar-archivist-researcher, and the acumen of the best financial analyst-cum-fund manager, and with the disclosure mindset of the best public limited companies will succeed the most. These are nascent and pioneering days.

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GLOBAL FUND NEWS

The value of expertise in art investment funds

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are pension funds. Our purchases are always strategically planned and backed by detailed research and a due diligence process. Given that we look at art purely as an investment, we never buy a work of art because we like it aesthetically; we only buy in order to seek longer-term capital growth for our investors. However, as many members of the team are indeed passionate about art, we do understand the importance of exhibition and viewing of artworks. For this reason, we are happy to loan our works to institutions or to investors themselves, for them to hang in their homes or offices for enjoyment. Artworks owned by the Group have traveled the world in prestigious exhibitions, which only increases their inherent value.

Nowadays, succeeding in the art world, especially as an Art investment group, remains a very difficult task. The degree of speculation and the overheated nature of the market can be great threats to success. In addition to understanding the workings of the market, one needs to closely follow and monitor both the general trends and the daily developments of various submarkets in order to access the great deals and to eventually exit those deals, in order to make a strong return for ones investors.

In the context of the current financial markets crisis, it is difficult to predict how the art market will perform in the near future. The only thing we can claim with certainty is that art is definitely a long-term store of value. We are confident that there are areas of the art market where profits will be found and that our unique team of experts will continue to exploit them with success.

RECENTLY ANNOUNCED ART FUNDS

Meridian Emerging Art Markets Fund

Prime Art Funds

Castle Apollo Fund Limited

Dean Art Investments Fund

The India Asia Arab Art Fund

Daman Middle East Art Fund

Advanced Capital Art Fund

Marquee Capital Entertainment Memorabilia Fund

ABOUT FINE ART WEALTH MANAGEMENT (FAWM)

FAWM is the first wealth management consultancy dedicated exclusively to art, collectibles and other investments of passion as an alternative asset class and the disciplines required to analyse this complex field of investment. We are wealth structuring specialists in art assets and passion investments and the leading provider of intelligence on art investment funds to wealth managers, private banks, family offices and professional advisors.

FAWM was founded with the singular vision to bring the inherent investment attributes, and the business of art, collectibles and other investments of passion to qualified investors. We provide art fund identification and assessment services to institutional investors. By adopting a rigorous, exhaustive and transparent process combined with comprehensive coverage of all art fund managers, we seek to provide the most appropriate offering for qualified investors.

ART FUND REGISTER

We are pleased to announce that after some initial delays, the “Art Fund Register” was launched this month providing an exclusive platform for art fund managers wishing to gain broad based exposure to vetted investors. Art Funds registered on the site will also benefit from additional promotion and branding through the research and newsletters that we publish.

Through the tender platform, FAWM actively endeavors to maintain comprehensive coverage of art investment funds globally.

However, given the rapidly evolving and fragmented nature of the global art fund market, we understand there will be fund managers with whom we have not been in contact. If you would like to know more about FAWM, our activities and how to express interest in forthcoming searches, please contact us at www.fineartwealthmgt.com

FAWM guarantees the confidentiality of all information provided by art fund managers through this website. Equally, information contained within offers will only be shared with the organisation awarding a mandate.

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GLOBAL FUND NEWS

Capitalizing On The Emerging Art Market Opportunity

(continued from page 6)

the effects of such a phenomenon. In 2007, China overtook France to become the third largest art market by volume in the world after the U.S. and U.K. The best work by Chinese, Indian and Russian contemporary artists regularly is featured in prominent museum and gallery shows in London and New York, and they have garnered some of the highest prices at Sotheby's and Christies' major evening contemporary art sales over the past two years. It is only a matter of time before the same may be said of the best work from Indonesia, Iran, Nigeria and Brazil, among others.

The writing is on the wall. The art market is ripe with opportunity, and investment grade contemporary art from the world's emerging markets is the best area to realize exceptional gains. An institutional grade structured investment vehicle, such as the Meridian Emerging Art Markets Fund, offers sophisticated investors throughout the world an opportunity to diversify their investment portfolio with very little risk and realize returns one could not expect from investment in any other investment vehicle, much less the equities markets.

COMING SOON

In addition to the Art Fund Tracker, Over the coming months FAWM will be introducing a series of other leading art fund publications including:

- Art Fund Data Base and Directory
- Art Fund Profile Service
- Art Fund Reports by Region
- Art Wealth Management Events

Because of the investment nature of this information, our publications are available to qualified investors and industry professionals only. We carefully screen all of our subscribers and reserve the right to refuse subscription applications based on these criteria.

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GLOBAL FUND NEWS

Primary Art Market Investments – A Safe Haven When All Else Suddenly Correlates?

(continued from page 8)

sult in substantial losses as reflected by the differential between gallery and secondary market prices.

Longer term secondary market success crucially depends on credible and visible collectors continuously absorbing the gallery output at steadily increasing prices while not releasing too many works into the volatile auction market. Collectors of early stage emerging art therefore need a very long horizon if they intend to net a profit across their investments. The patience does pay off, however: Investing in one typical artwork at every exhibition of the galleries in our database since the early 1970ties would have yielded a theoretical average compound gain of 17% p.a. after a mean holding period of 18 years.

Prime Art Management Ltd. reduces this rather ungainly time span to 6-8 years and bypasses the secondary market as a resale channel completely. Our asset selection happens at the gallery level rather than the artist level, enabling us to determine the potential of young artist and to invest in their developing oeuvre long before they appear on the radar screen of competing investment instruments. Our system thus systematically and persistently captures the window of greatest price appreciation in the first years of an artistic career. By acting as an aggregator of information about the individual collector pools of our partner galleries we furthermore generate the knowhow necessary to manage buyer-side liquidity across our supplier portfolio to ensure a high degree of asset conversion regardless of macroeconomic conditions. Cautious backtesting currently results in compound returns for investors (net of fees and costs) of 13% with an exceptionally low volatility of 3% (1 STD) over the last 11 years assuming fund terms of 6-8 years. Correlation with any major asset class as well as secondary market art is, to date, virtually nil in our current gallery sample.

About the Author

Dr. Gerber is Founding Partner and Chief Executive of Prime Art Management Ltd. (www.primeartfunds.com), an econometrics-driven asset management and art market information business specialising in the primary market for emerging art. The company aggregates and monitors first-hand gallery sales data across the globe. Having developed the only robust econometric framework for modelling pricing mechanisms in this market, it is now preparing the launch of “Prime Art Funds”, the first investment instrument focusing exclusively on high-potential early-stage emerging art - a field previously inaccessible to systematic investing.

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GLOBAL
FUND NEWS

Emerging Liabilities in Managing and Investing in Art Funds

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funds can no longer manage the title risk simply by declaring that the fund follows traditional art industry due diligence practices. A fund must disclose the measures it undertakes to overcome the following items yet still meet investor returns and exit goals: (i) lack of transactional transparency in the art industry; (ii) ineffectiveness of private warranties of title and indemnities from sellers; and (iii) the inherent risk of loss due to unlimited warranties of title the fund must give when selling privately or at auction or due to the right of auction houses to rescind against sellers and buyers (art funds normally buy and sell at auction to assure neutrality).

Contingent Liability Reserves. Art investment funds which self-insure against the title risks must reserve funds to cover this contingent liability, which will affect forecasted returns, exit horizons and disclosure obligations. How will an art fund, which is not in the business of insuring title risks, determine with actuarial soundness how much money to reserve and for how long? The failure to reserve adequately or at all will expose fund management and investors to future liabilities.

Tax Structures. Many U.S. art funds are designed to employ IRC Section 1031 "like-kind" exchanges and to pass on the tax savings to their U.S. investors (the requirements of like-kind exchanges of art are beyond the scope of this article). Funds which engage in IRC Section 1031 art exchanges must reserve for the tax, interest and penalty consequences of like-kind exchanges which are legally void because the fund did not acquire clear legal title to the replacement work in a forward exchange or because the fund was unable to complete timely the sale of a relinquished work in a reverse exchange when a title defect derailed the private or auction sale at the last minute.

Audit Requirements. Financial auditors are now gaining familiarity with the art market and the implications of defective legal title on art fund assets. One can expect that auditors will increasingly require art funds to disclose unmitigated ownership risks in the fund's financial statements, to report reserves against these risks and to demonstrate an actuarially sound basis for these determinations. Absent adequate compliance, funds likely will be unable to secure unqualified audits to meet their reporting requirements. These challenges will compound as art investment funds increasingly solicit and accept funds from institutional investors, which have comparable audit requirements.

An art fund's only alternative to self-insuring against the title risks and to assuming the related disclosure and other challenges is to secure title insurance for the inventory of artworks in the fund. Title insurance for art has evolved as a means to provide certainty of legal ownership (and asset value and liquidity in turn) just as title insurance secures investments in real property. A market-neutral insurer with regulated confidentiality obligations can access transactional information that is traditionally blocked from principals. As with real property title insurance, key features of art title insurance are: (i) a one-time premium for coverage for the life of ownership of the work (and the life of ownership of the heirs at law for individuals); (ii) no deductible; (iii) full indemnity for the value of the art based on the purchase price or a fair market value appraisal for owner-in-possession policies; and (iv) defense costs outside-the-limits, that is, in addition to the indemnity for the insured work. Policy endorsements provide for increases in limits for works which appreciate in value after the policy incepts.

Art title risks apply to all types of art in which art funds invest today contemporary art to old master "works", rare books and manuscripts to vintage automobiles and rare stringed instruments. Proactive art investment funds now incorporate art title insurance into their business models for all works in order to protect consistently and uniformly investor funds and art investment returns.

Although art investment funds can offer new opportunities for potentially significant returns, important to their success is the proper understanding and management of the title risks which are inherent in buying, selling and owning art.

Key Art Title Statistics

25%	Percentage of risk due to **art theft** – contemporary (e.g., Steven Spielberg's stolen Norman Rockwell painting) and historical (e.g., WWII Nazi-Era theft) plus illegal export/import.
75%	Percentage of risk due to **traditional liens and encumbrances**, (e.g., lack of authority to sell, divorce, estate issues, corporate authority, fractional ownership, etc.) outside the sphere of traditional art industry due diligence.
33%	Percentage of **contemporary art theft not reported** to law enforcement.
5%	Percentage of **stolen art recovered** by law enforcement.
$6B	**Stolen art per year globally**.
16%	Percentage of total risk potentially covered by **stolen art databases**.

Lawrence M. Shindell, J.D., is Chairman & CEO of ARIS Corporation. ARIS is the world leader in art title insurance and serves the art market and the fiduciary banking, legal, museum and broader non-profit communities. For more information, visit www.aris corporation.com.

LEGAL, TAX AND REGULATORY

The Luxembourg Specialized Investment Fund (SIF)

(continued from page 10)
From a tax perspective, a SIF is sought to achieve tax neutrality for the investors at least from a Luxembourg perspective through the following characteristics:

- No capital duty upon capitalization or incorporation of the SIF

- No application of Luxembourg net worth tax

- No withholding tax except application of the EU Savings Directive

- No application of Luxembourg income tax but instead a subscription tax of 1 basis point on the net asset value (NAV) of the fund while standard Luxembourg UCIs are in principle subject to a subscription tax of 5 basis points on the NAV.

Unlike other Luxembourg vehicles such as the Soparfi, SICAR, or Family asset management company (SPF), were exemption is limited to certain types of income in shareholdings, securities or financial assets, the absence of income tax for the SIF is of general nature, and could thus apply to investments in art provided that other regulatory conditions can be met.

As a matter of fact, after only one year of existence, the Luxembourg SIF vehicle already proven its attractiveness as an alternative investment fund vehicle in specific fields such as investing in prestigious wines or pieces of art.

As for other investment funds, the following parameters in the home country of the investor will be important to assess the ultimate tax efficiency of the Luxembourg investment vehicle for the investors (individuals or corporate):

- Income stream taxation in investor's home country:

Does the investor benefit from a favourable tax treatment or exemption on dividends or capital gains?

- Tax transparency and reporting:

Is the vehicle transparent for tax purposes in the investor's country? Given tax transparency of the funds at the investor level, when is the investor taxed? Does the investor needs a specific reporting for tax purposes?

- Controlled foreign company rules (CFC):

Depending on the degree of control (individual or collective) over the foreign investment vehicle and its tax status CFC rules applicable in various states allow investors to be taxed even if no income is distributed by the Luxembourg vehicle

From a VAT perspective

An investment fund is recognized as a taxable person for VAT purposes and this status usually leads to a basic obligation to register for VAT.

One of the main VAT advantages would be the VAT exemption of services which would be specific to and essential for the management of the SIF.

To the contrary, the question of the deductibility of any input VAT paid by the SIF should be carefully considered when deciding who will be the stock owner of the pieces of art.

Depending where the pieces of art may be purchased, stored and sold (for instance in Luxembourg, in Switzerland or in the United Kingdom…), this could lead to a multiplication of the VAT and customs duties requirements for the stock owner.

Conclusion

Provisions in the new Luxembourg SIF law make a SIF an interesting investment fund option to consider for investment in art. While the Luxembourg direct tax characteristics of the regime are certainly attractive from a Luxembourg perspective, VAT implications need to be carefully studied within the project and from an investor taxation perspective as it will be important to assess how flows of income arising from this vehicle are treated tax wise in their country of residence.

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1 The rate is expected to decrease to 28.53% in 2009 (included in 2009 budget law not yet voted) and further gradual decrease has been announced by the Luxembourg government.

2 Article 8 of Luxembourg Net Wealth tax law provides a possibility of neutralization of net worth tax charge up the amount of Luxembourg income tax charge due for the same year if the company allocates an amount representing five times net wealth tax due to a special reserve for a five year period.

3 Introduced by a law of 13 February 2007.

4 As defined in directive 2006/48/CE.

5 As defined in directive 2004/39/CE.

6 As defined in directive 2001/107/CE.

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LEGAL, TAX AND REGULATORY

Gibraltar – An EU domicile for specialist Art Funds

(continued from page 11)

tion, the similar aspects of which are available in most other jurisdictions. For example, a Trust formed using law outside Gibraltar but having Gibraltar resident Trustees, can hold assets worldwide. In cases where the beneficiaries are not Gibraltar resident, all Trust income and capital gains arise tax free. Similarly the assets are not liable to any Inheritance Tax, gift tax, VAT, sales based taxes or any other customs levy. However in addition to these, in 1990 Gibraltar introduced specialist legislation to give added protection for the long term holding of family assets. This enables families for example, to place art collections and other assets into a specifically formed Trust. Provided the settlor was solvent and not subject to any threatened litigation or wealth depreciating act or circumstance at the time the Trust was made, the assets are completely free from attack in the future. This is unlike law in most other jurisdictions which enable creditors arising at some future time to attack family assets, sometimes without limit. Material wealth of art collections built up often through generations may therefore come under attack, sometimes in unexpected circumstances. The current financial crisis may have put pressure on some family wealth derived from equity and financial instruments and this may in some cases force the realisation of art based assets. Similarly, creditors may be able to force the sale of the personal assets if not adequately protected. In the most extreme circumstances, individuals could face severe liquidity problems and even bankruptcy. In that event, using these specialist asset protection Trusts would have ring-fenced and protected such assets, including art.

Now would be an ideal time for individuals to review their medium and long term asset protection planning. It is simple to form the necessary vehicle. Assets can still be retained in the individual's home country without restriction. Where assets are encumbered, such as with a charge by a bank or lender, transfers into the Trust can usually take place subject to the lender's consent.

Most jurisdictions recognise the separate legal entity of Trusts. Depending on the country of residence of the settlor and beneficiaries and local law, it is often possible for the Trust assets to eventually be placed outside the estate of the original settler, either straightaway, or over time. Laws differ considerably between countries. However a general principle enabling art to be retained following death of one generation, is usually better achieved via a Trust structure. The passing down of family wealth to the next generation and control of it, is also usually an important issue. A Trust provides the background to appropriately appoint a third party specialist or trusted professional to ensure the following generations do not dissipate assets against the overall will of the original family settlors. Hence protection from spendthrift grandchildren can be guaranteed by in-building the correct protection procedures from the start. Trusts do not hamper the purchase and sale of further art based wealth. Often the Trust uses a holding company to own the art. The holding companies are set up in tax neutral jurisdictions and the set up and formation cost is minimal.

Steven Knight, Managing Director, The Castle Trust Group

Steven is a UK qualified Chartered Accountant, a member of the Society of Trust and Estate Practitioners and the Institute of Directors. Formerly of Coopers & Lybrand and Touche Ross, he was appointed to start up and manage the Gibraltar office of Price Waterhouse in 1989. He established the Castle Group in 1992 and is widely considered as a specialist in international tax planning for both wealthy individuals and companies. Steven holds a company manager license issued by Gibraltar's Financial Services Commission in relation to the provision of Directorships to Experienced Investor Funds.

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