

Risk Management of Tangible Assets

Introduction

The 2008 financial crisis was a harsh reminder to many investors of the instability of the global financial markets and the risks associated with owning stocks and shares. High net worth individuals (HNWIs) appreciated, perhaps for the first time, the true value of owning valuable collectables with no correlation to the financial markets.

This has encouraged a surge of interest in the acquisition and collection of fine art, classic cars, wine, furniture, jewellery, antiques, yachts, race horses, sports memorabilia and other movable chattels, collectively known as “Tangible Assets” (TAs). A better definition is probably tangible movable property as it doesn’t include real estate or fixed assets like machinery and equipment.

In 2012 a Barclays Bank survey reported that 9% of HNWIs’ total funds were invested in TAs. 74% of those surveyed cited that capital appreciation of assets that tend to hold their value during market fluctuations was a deciding factor. In other words, buying fine wine and classic cars is now seen as being a prudent investment in addition to being just a hobby.

Furthermore, TAs are now recognised as their own asset class, and can join the ranks of the standard list of asset classes of equities, fixed income, cash and cash equivalents, real estate, commodities and derivatives.

This is significant, and means opportunities not only for those with an interest in aesthetics, particularly art dealers, appraisers and other connoisseurs, but also those who may be unfamiliar with this field.



The problem is that many families are just not used to keeping track of their TAs. Until recently, TAs were often not even considered part of the overall investment portfolio. This has resulted, understandably, in what has been termed a “High Net Worth Blind Spot”. Because people have not been used to professionally managing their TAs, the whole area is sometimes quite simply overlooked.

Although many family offices and trustees may be familiar with the management of TAs, many may not be, and this is a risk. In other words, they need to apply traditional risk management principles to TAs, as they do to the other asset classes.

Risk Management

Risk management is a process developed over the ages which involves the identification, measurement, assessment, control and financing of risk.

Risk management, like many things, is applied common sense. Since time immemorial, fine art enthusiasts have been looking after their collections very well, and much of what follows is simply applying those same, tried and tested risk management measures to the whole TA portfolio.

Risk Identification

The first stage in the risk management process is identification. This is divided into two parts: the identification of all the TAs and the identification of all the possible risks that could affect them.

This part of the process primarily involves making lists of all the assets. This can be a daunting task, especially, for example, in cataloguing the contents of large and dusty old libraries in different countries. However, it needs to be done, and once the records are in place they can easily be monitored and reviewed. On the back of this new interest in TAs, a number of very sophisticated software applications have been developed to help track this information. These are designed to make the management of TA risks easy and even enjoyable, as the applications can also be enhanced to allow HNWI's to share their art collection with dealers and other collectors.

Each of the items needs to be identified and catalogued with as much information gathered at the same time, including photographs, original valuations, proofs of provenance and as much history about the object as possible. It's probably clearer now why a specialised piece of software can make life much easier for everyone concerned.

Risk identification is best carried out by an expert risk engineer or a loss prevention specialist, who is familiar with inspecting and surveying TAs and how and where they are stored. Loss prevention is critical especially regarding TAs that are prone to physical damage, theft or the ravages of time. This exercise will form the basis of the Risk Control stage, which follows below.



Risk Measurement & Assessment

The valuation of TAs is a specialist field, and will involve expert appraisers. While the TAs are being valued, the assessor should also ensure that the necessary paper work showing proof of ownership and authenticity is in place. This is especially important for fine art which could be many hundreds of years old and have had many different owners from all over the world.

The result of the Assessment stage will be up-to-date valuations of each of the assets and a review of all the underlying documentation. This will then help to ensure that all the TAs are properly covered by insurance at the correct value.

Another important feature of risk assessment is the calculating of the probable maximum loss in the event of one type of risk. For example, if there is a fire in one of the owner's houses, and everything is lost, what is the total value of TAs at that particular location? This is important not only for insurance purposes but also for improved risk control to encourage a better spread of risk among various locations.



Risk Control

The assets have been listed and valued, and the risks that each face have been identified by the loss prevention expert. It's now time to control those risks. There are two types of control, pre-loss and post-loss. Pre-loss control is put in place to help avoid a loss in the first place, e.g. avoidance is an obvious and often overlooked pre-loss control. Examples include security systems and storage of wine at the correct temperature. Post-loss control comes into action once the event has occurred, and is designed to minimise/mitigate the final loss. Examples include sprinkler systems, and disaster recovery plans.

The loss prevention advisor will most certainly recommend that the Caravaggio is not displayed above the active fireplace where the heat and soot will accelerate its deterioration and lessen its value. This simple pre-loss control could save millions of dollars.

Risk Finance

This is an interesting area, often misunderstood. This can be achieved by risk transfer or risk retention.

Risk transfer can be arranged by contract or by insurance. An example of contract would be if you decided to lend your art collection to a museum, and transfer the risk of all losses to the museum as part of the lending agreement. Insurance would be when you purchase external insurance to protect the assets in transit to and while at the museum, yourself. In practice, a combination of both contract and insurance is used – belt and braces.

Risk retention can be unintentional, if the broker has not been informed about the purchase of a 1954 Mercedes-Benz for US\$30m, or intentional, if a conscious decision not to insure the TA is made. You may believe that the 30 ton white

marble replica of the Caesar Augustus of Prima Porta in your garden is too large to be stolen or damaged so you are willing to take the risk yourself and not have it insured. Another fascinating alternative to self-retention for the sophisticated HNWI is captive insurance, which will be covered in a separate paper.



Estate Planning and Asset Protection

This relates to tax and succession planning and the protection of the estate from creditors and foreign governments. This specialist area will more than likely be well managed by the existing family office that will have access to the expert advice of attorneys who specialise in these areas. There may be a number of family trusts, foundations or offshore holding companies that have legal ownership of the assets, which will need to be taken into consideration. These advisors also play a critical role in the protection of all the family assets, and should most certainly be included in the management of TAs.

Conclusions

As global sales of classic cars, wine, diamonds, precious gems and fine art continue to rise and represent a higher proportion of HNWI total investment portfolios, there is going to be an increased demand for risk management services. As seen, due to the complexity of a good risk management programme for TAs, the only way this is achievable is to have proper project management in place, i.e. somebody to manage the process, probably the family office. The family office, with the right tools, would manage the whole risk management process by gathering the necessary team of risk prevention consultant, fine art appraiser, tax attorney and insurance broker.

The risk management process should be dynamic, designed to pick up all changes to the TA portfolio as things are bought, sold, appreciate or depreciate. It should also be part of a larger risk management plan, which would include guidelines and processes with respect to TAs, for example, a checklist of things to be done before buying a new piece of art – a thorough search to ensure that the item has not be stolen, purchase through a reputable dealer and expert advice regarding the provenance, authenticity and valuation of the item.

The risk management of tangible assets is a growing area which involves the management and cooperation of people from various fields of expertise working closely together for the protection of beautiful works of art, be they a good wine, antique maps or old cars, i.e. the investments.

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