Smith & Hall Collapse Sends a Chill through SMSF Sector

By Jane Raffan, on 13-Oct-2010

Having recovered from the tremors of the Cooper Review recommendation to ban art as an asset class in their Self Managed Super Funds, trustees will now have to overcome the rolling aftershocks, including potential loss of value across holdings, and financial imposts associated with impending government regulation.

The collapse of Smith & Hall (formerly Galleries Direct) is reported to involve 800 works of art with a value in excess of $4 million[1]. Today's coverage in the Financial Review reveals the company's modus operandi behind their business model, whereby investors were induced to purchase works on the promise of capital gain, in addition to a dividend style income stream from the works being leased out with a guaranteed rental return of between 6% and 8% a year.

What the article doesn't reveal is that Smith & Hall specifically targeted investors of Self Managed Super Funds (SMSFs). Various company marketing spiels indicate that their investment model was "particularly popular with owners of self-managed super funds…", and provided "…a healthy income from the asset, while it is potentially appreciating in value".

The leasing angle is an attractive element of the investment pitch because of the Australian Tax Office's controversial 'sole purpose' test, which prohibits trustees with art holdings from enjoying the *additional benefit* of having their assets on the walls. The Smith & Hall model, used by several other investment operators, appeals to 'art lovers' because the rewards wrap pleasure and profit together in an emotionally satisfying bundle.

But in the end it's the lure of profit that clinches most deals.

In 2009, an article from one of the many online magazines devoted to superannuation issues promoted Smith & Hall as having provided art market analysis that showed Aboriginal Art outperforming other art investment options, with a yield of 24.8% compound annual growth rate (CAGR) compared to 15.1% for other blue chip artists.[2]

The article further extrapolates these statistics to suggest that "an initial investment of $20,000 in Aboriginal art or blue chip Australian artists five years ago becomes valued at $58,000 or $40,000 respectively." When Smith & Hall exhibited works in Dubai in 2008 (as Galleries Direct), they promoted a compound annual growth rate for Aboriginal art at 34.1%.[3]

What the article doesn't account for, is that art is commonly sold to SMSF investors at retail prices, and secondary market trends suggest that 5 years is the absolute minimum, in most cases, that one should expect to hold works of art purchased retail before to seeing *any* return on the secondary market; 10 years is a more realistic assessment and that's without the gamble of buying works by artists who don't perform.

Investing in works by contemporary artist for capital gain is a gamble by nature, and this applies to Aboriginal art as much as non Indigenous art. And the Aboriginal art sector has great complexity due to the vast array of practising artists and diversity of styles, in addition to the volume of work available from a large number and variety of sources.

Investors in SMSFs need to consider the implications mooted by the Federal Government in the wake of the Cooper Review debacle. While rejecting its recommendations to ban art as an asset class, the Labor Government has indicated it will bring in new regulations for SMSFs from 1 July 2011. For trustees with art holdings, these regulations will potentially impact the value of their holdings, as well as their purse.

From all accounts the SMSF sector largely comprises investment in Aboriginal art over non Indigenous Australian art.[4] And for this reason alone it is highly likely that the Government would have introduced specific and separate regulations for art holdings. For some time now they have been targeting the Indigenous art market, in particular, with increased oversight and regulation.[5]

Amid the drama of the Cooper Review, the SMSF Professionals' Association of Australia drafted 'Best Practice Guidelines for Acquiring and Holding Artworks in an SMSF', which were accepted in principle in July.

Should these guidelines be formally adopted, SMSFs will be required to make a number of significant changes to the management of portfolios. Lowensteins Arts Management has reported that each SMSF will require a 'Specialist Advisor' to advise on the acquisition of artworks and ensure that purchases are within the broader investment strategy of the fund.[6]

In addition, one mooted guideline is for the requirement of acquisitions to be independently valued on an annual basis, and only by appropriately qualified valuers. There is no such current requirement, and this measure will place significant responsibility and financial imposts on SMSF trustees who will need to marshal resources for sourcing and paying for valuations.

And as a result, SMSF trustees may find the value of their holdings downgraded. It is not uncommon for some sellers to provide valuations at time of sale in excess of a 'discounted' purchase price, and regulated asset validations will need to be assessed for fair market conditions and not retail replacement.

And what of the Smith & Hall holdings reportedly worth $4 million? Book values can range from purchase price to insurance values, and asset liquidation valuations are usually dramatically different to retail values.

The administrators are now on the case and given current market conditions it is likely that this figure will keep changing. This is potentially bad news for the SMSF creditors whose holdings, if recovered, may be dramatically devalued.

And adding injury to insult, some investors may have taken out financing for art purchases, a common enough practice amongst collectors and another featured service provided by Smith & Hall.

SMSFs should not be discouraged from buying art, which has been demonstrated time and again to be a worthy asset class, and which continues to achieve stronger capital gains than many other investment options.

Given this prospect they should, however, seriously consider supporting their strategy with purchases through entities with proven expertise, whether they are consultants or dealers, and irrespective of whether the works are sourced from the primary or secondary markets. The extra outlay, a miniscule amount when weighed against potential returns, should prove to be a worthy investment in itself.

[1] Katrina Strickland, 'Collapse not a pretty picture', Financial Review, 14 October 2010, p24.

[2] Kerry Lotzof, A Picture Perfect Investment', 1 September 2009, Superliving, http://www.superliving.com.au/storyview.asp?storyID=1034500&sectionsource=IND%3A+SL+Feature

[3] Soura Magazine, p29, http://www.artdubai.ae/documents/ArtDubaisupplementwithSoura_000.pdf

[4] See media and commentary, Save Super Art Campaign, http://savesuperart.org.au

[5] Jane Raffan, 'Moral Lip Service, Government's Hard Hit at the Art Market is a Soft Form of Redress', SAM, March 2010, http://sydney.edu.au/alumni/sam/archive/SAM_March10.pdf

[6] Lowensteins Arts Management, Tax Matters for the Arts, September/October 2010, p1.

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The Australian Art Sales Digest is published by John Furphy Pty. Ltd., Melbourne, Australia.