Spears Wealth Management Survey

The Canary in the Mineshaft

Pink Panther (1998) by Jeff Koons, image courtesy of Sotheby's.

Where the art market leads, the stock market often follows. If what's been going on at Sotheby's lately is any kind of indicator, there are hard times to come, says Ivan Lindsay

FOLLOWING THE RECENT two-week marathon of art sales at the leading auction rooms and a difficult three nights for Sotheby's, the Sotheby's share price has turned down, halting a breathtaking ascent that took it from its 2009 low of 7 to its recent high of 54 on the New York Stock Exchange. The fall took the share price down to 40, a loss of more than 20 per cent in a month and a half. In the past, such drops in the Sotheby's share price have been an early warning of trouble ahead in the art market and also for the broader stock market.

Since Sotheby's was listed in 1988 it has been sold off early in the Nikkei, dot.com and recent mortgage bubbles, proving itself a lead indicator. Most recently, for example, Sotheby's stock started to fall in November 2007, rapidly dropping by more than 40 per cent, while the broader stock markets did not start to sell off until some months later and only achieved major declines by late 2008.

Sotheby's share price is a reflection of the health of the company, the trend of the art market and the general direction of the stock market. Since the last of these appears still to be up, investors must be concerned about the art market and the health of the company. The recent news that appears to have spooked investors is probably partly the less-than-stellar recent sales results and partly Sotheby's announcement of its first-quarter sales results on 9 May.

The quarterly results followed on from record figures for 2010, the best for Sotheby's in its 267-year history apart from 2007. The 2010 consolidated sales were $4.8 billion, the operating income was $274 million and the balance sheet showed cash at the year-end of $483.7 million. Bill Ruprecht, the president and CEO, seemed pleased with 'a much lower risk profile than in the previous peak years of 2006 and 2007' and called the results 'a remarkable achievement'.

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The first quarter has traditionally been a loss period for the company, but Sotheby's reported a net income of $2.4 million for the 2011 first quarter and Ruprecht said: 'This is one of our best first quarters on record… Sales are up year to date by 31 per cent.' Less impressive were the operating costs, which, having been reduced in the downturn, rose by 16 per cent. Sotheby's and Christie's both tend to over-expand in the giddy bull markets of the art world and then have to slash costs in downturns.

In addition to the increase in operating costs, it may be that some of the less than transparent business practices that have emerged in this boom are starting to concern investors. It seems that when the art market is on fire, and with fierce competition from other auction rooms for business, it is tempting to start pushing business practices to the edge. This famously led to the price-fixing scandal of the Nineties, when the chairman of Sotheby's was prosecuted and jailed.

More recently, it is the 'irrevocable bid' that is attracting adverse attention. This is the practice in which the auction room extracts a third-party guarantee that a person will bid at a certain level at the sale. In return, the guarantor is promised either a fee or part of the upside if bidding continues above their bid. If no higher bid is made, they buy the painting at that price.

Needless to say, this has a skewing effect on the auction and, while probably technically legal (although untested in the courts), the sale cannot be said to be a public auction. Allan Schwartzman, the leading New York art adviser, was recently quoted in The Economist, saying: 'These sales are no longer auctions. To attract material at the top end, auction houses pre-sell the material to "irrevocable bidders". They are deliberate, orchestrated events.'

Such sales create misleading benchmarks that override the normal rules of supply and demand. The odd sheikh from Qatar or tycoon from Ukraine might believe he is actually participating in a real auction but others, closer to the action, are increasingly concerned about the real value of some of the more widely traded artists.

Take Warhol, for example. On the surface, all looks dandy for Andy and works by the artist accounted for a staggering 25 per cent of the week's takings in the recent contemporary sales at Sotheby's, Christie's and Phillips de Pury, totalling $181 million. That $181 million was made up of 54 works by Warhol. Nothing was left to chance and a small group of auction-room staff, dealers such as Jose Mugrabi and Larry Gagosian (sometimes in partnership), and collectors such as Peter Brant, Eli Broad and Steve Cohen are buying and selling and supporting prices by underbidding.

Mugrabi bought his first Warhol shortly after the artist died in 1987 and is believed to have 800 of his works. Gagosian entered the Warhol market in the mid-Eighties and was also closely involved in the markets of most of the other contemporary artists being sold.

ONE OF THE major Warhols in the sales was Sixteen Jackies, a posthumous collection of small 1964 portraits of Jackie Kennedy, fifteen of which were bought from Warhol's estate. The arrangement of the sixteen 'Jackies' had nothing to do with Warhol and was actually put together by the owner and seller, Brant, who was advised by Jeff Koons. The piece was supported by bidding from Mugrabi, who, with his sons, also underbid two other Warhol paintings at Sotheby's and bought two more at Christie's. The piece sold for just $18 million on the reserve against an estimate of $20–30 million.

Elsewhere, Sotheby's had clearly overestimated several of the major lots that failed to sell, such as Lichtenstein's Half Face with a Collar (unsold at $11 million) and Freud's Naked Portrait Standing (unsold at $6.75 million). Koons's Pink Panther, apparently one of his more important works, shows a porcelain bust of a blonde woman clutching one of her breasts in one hand and a model of the cartoon feline in the other.

Sotheby's gravely informed potential purchasers that it was from an edition of three, the other two being in the hallowed halls of the Museum of Modern Art in New York and the Museum of Contemporary Art in Chicago, and that this example came from a prestigious private American collection. It sold on an irrevocable bid for $15 million, having been expected to go for $20–$30 million. This did, however, represent a huge increase on the $1.8 million it fetched at auction in 1999.

In conclusion, it appears that the art market is currently overhyped and being manipulated, and investors in Sotheby's are taking their profits. They may also sense problems coming in the economy and feel that this will be felt early in the art market and have an impact on Sotheby's figures. As Goldman Sachs said recently, 'Equity prices are a lead indicator of GDP growth and react strongly to expectations about the future.' Only time will tell whether the Sotheby's stock price correction is just a pause as the market catches its breath after its dizzying increase since 2009 or is the start of a serious correction. If its past performance can be any indication, then it might be time to exercise some caution.

After the recent contemporary sale at Sotheby's, the auctioneer, Tobias Meyer, expressed his gratitude to the 'collector community' who had 'supported the sale'. It remains to be seen whether that was life support.

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