# THE INTERNET AND ITS IMPACT ON INVESTING IN COLLECTIBLES

By James B. Cloonan

There are many positive reasons to invest in art and other collectibles, but in the past investors have faced high transaction costs. The Internet, however, has introduced the possibility of reducing these costs for many collectibles, and this change may migrate even to very expensive areas.

It's been a number of years since I have discussed collectibles as an investment alternative, but there are several changes in the market that make it worthwhile to view it again and emphasize a few realities about collectible investing.

First, the advent of Internet auctions is reducing the transaction cost for many collectibles, and it seems likely that this change will migrate even to very expensive categories.

Second, the Internet provides the opportunity for direct contact between collectors in most areas, which can lead to private sales. In the past, coin and stamp collectors have had the opportunity to trade among themselves, which substantially lowers their transactions costs. In contrast, art, antiques, books, antiquities and artifacts have usually had very high transaction costs because very little opportunity has existed for collector-to-collector transactions.

In many of these areas it would not be unusual for a dealer to charge twice what he would be willing to pay for an item. At auction, both the buyer and seller pay a premium to the auction house, and the round trip will average over 25% in commissions, plus a spread theoretically equal to the bidding increment.

For example, let's say you go to an auction house and bid up to $25,000 for a Picasso print. You are the successful bidder as the previous bid was $23,000. You pay $25,000 plus 17.5% or $29,375. Immediately, you decide it was a mistake and put it up to auction the next day (not possible practically). The person who bid $23,000 is there and bids up to that amount. There are no more bids because you were the only one willing to go to $25,000 the prior day. You receive $23,000 less a 10% commission or $20,700. You are out $8,675 in transaction fees that have nothing to do with the value of the print. And you will be out the equivalent of this amount even if you or your heirs sell later and the print has gone up in value. It will be a reduction in gain rather than an actual loss but it costs you just the same. The perceived value (hammer price) has to go up 30% for you to break even. If you want to make it worse, imagine that you also paid a 9% sales tax on the purchase, which you don't get to recover.

There are many positive reasons to invest in art and other collectibles, but you can see that reduced transaction costs would make it much more appealing.

Another change that makes collectibles more appealing is the disappearance of gold as a monetary good or hard asset. There are still a few gold bugs out there, but gradually nations and individuals are willing to give up its monetary significance. Gold is now strictly a commodity, and like any commodity speculators can make money on its price fluctuations, but long-term holders won't keep up with inflation. [I have devoted several columns over the past decade explaining the reasons for this. The gold bugs say I don't understand that gold is a hedge against catastrophic times. But for total safety and as a hedge against almost anything, you are better off with U.S. Treasury bills. Gold has not been a hedge against inflation. In addition, over the last 25 years we have had near-wars, market crashes, oil panics, nuclear accidents and Y2K threats—and gold has not hedged against any of them. The only thing that Treasury bills won't hedge against is the collapse of the U.S.

*James B. Cloonan is chairman of AAII.*

government. And if that happens, I'll take weapons and food over gold.]

Reduction in the transaction costs and the possible need for an asset class that does hedge against inflation makes collectibles more appealing. But not all collectibles are the same. Some will appreciate rapidly, some will just keep up with inflation and others will lose their value as tastes change. The factor that will make collectibles shine as an investment is the pleasure (utility) they provide on an ongoing basis. They can provide an annual dividend that is not taxed. This only occurs, however, if you are a "collector," meaning that you enjoy either the collecting or the possession of the items collected. But one can be a collector and an investor at the same time.

It is often said that, if you are a collector, you should buy only what you like and not worry about future increases in value. This is a partial truth. If there is only one thing you really want, then you should go for it if you can afford it and think of it as an expenditure.

But there are several reasons for most collectors to be concerned with the value of what they buy. First, if you are buying long-term quality items, you can think of part of the purchase as an investment and part as an expenditure if it has a proven value over the years. If you buy something that has no history or market, you have to consider all of it as an expenditure. For example, if you had decided to keep that $25,000 Picasso print, you might look at the historical price variations and feel that no matter what happened, you would be able to realize $15,000 for it. That being the case, and assuming you had not already committed too much to hard assets, you could take $15,000 from your investment funds and $10,000 from you expenditure budget to pay for the print.

A second reason to consider future value is to help you decide what you should buy first. If there are two items you would like in your collection, it is wise to consider their potential appreciation over the short term and buy the one that may appreciate most quickly first. Otherwise, you will have to pay more for it in the future than you would have to for the slower appreciating item.

This is by no means a complete coverage of the area of collectibles, but only a reminder that they may be appropriate for some small percentage of your portfolio. Both the power of the Internet, either through collector-to-collector contact or E-auctions, and the changing status of gold may influence the desirability of collectibles as investments. ◆