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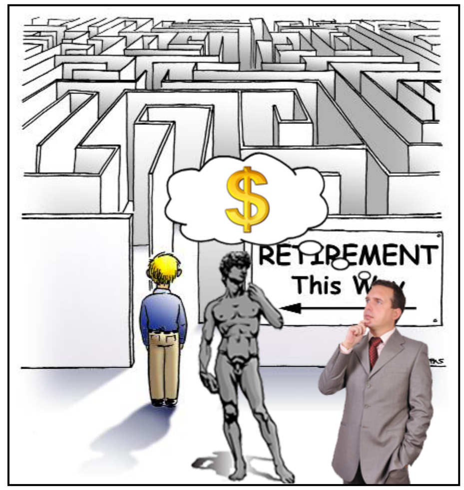
Don’t confuse collectibles with investments

Navigating the Retirement Maze



“If, after the first twenty minutes, you don't know who the sucker at the table is, it's you.”

– From the movie “Rounders” (Levien & Koppelman, 1998)

Prior to my career as a financial advisor, I dabbled in some collectibles in which I had an interest: rare coins and animation art. I knew something about coins, having been a long-time collector and was also familiar with resources available for assessing prices. I ended up making a small profit on my purchases and sales. Conversely, I knew next to nothing about the market for animation art, and suffered substantial losses when I needed to sell some of the pieces that I owned. In the process, I learned a lot about both markets, but it was an expensive education.

With both the stock and bond markets at historic highs, and news items about eye-popping prices being paid for art masterpieces, you might be thinking about diversifying your holdings into some collectibles. You should resist the urge.

Are you the smartest guy in the room?

If you aren’t intimately familiar with the valuations and market prices in a particular collectibles market, you’re at a huge disadvantage to those who are. In fact, there’s a name for you. (See the quote above.) Collectibles, particularly art, are notoriously difficult to price properly. Unless you do it for a living, prepare to get taken to the cleaners. Even if you do know something about the market, consider all of the dealers and buyers out there who know a lot more than you do. There may be a good reason that they all took a pass on the piece that you decided to purchase at auction.

It’s all about supply and demand

Highly talented athletes command such high salaries because they are in very limited supply, and there are many teams bidding for their services. The same supply and demand dynamic dictates prices in collectibles markets. The scarcest pieces that are desired by many wealthy collectors command seemingly exorbitant prices. More common items may be worth only a tiny fraction of those at the top of the market. Even if an item is scarce, it won’t appreciate significantly without a substantial increase in demand.

Collectibles can also be notoriously faddish. Remember the Beanie Baby craze? At the time, many people owned “rare” ones still in the original plastic bag, with thoughts of future riches. It was the modern day version of the Dutch tulip bulb mania, aided and abetted by eBay. Some were lucky with their buying and selling timing. More likely, most Beanie Baby “traders” were victims.

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The killer spread

In the stock market, highly liquid securities have a spread between the "bid" and "ask" prices – the price for which someone will buy a stock, and the price at which someone else is willing to sell it – on the order of tenths of a percent. Thus, if you buy a stock and then decide to sell it minutes later, the difference between your buying and selling price is usually small. In the world of collectibles, you're looking at commissions of 15 to 20 percent to sell an item at auction, and around 50 percent when working with a dealer. So the moment that you've purchased your collectible, you're already at a 15 to 50 percent loss.

Tax traumas for collectors

Collectibles have several disadvantages when it comes to taxes. First, unlike stocks and other securities held over a year that receive favorable tax treatment on their long term gains, those same gains on collectibles are currently taxed at a 28 percent rate or your marginal income rate, whichever one is lower. Compare that to the 0 to 15 percent tax rate that most investors pay for long term appreciated securities. Plus, if you exceed the income threshold for the Net Investment Income Tax (NIIT), add another 3.8 percent to your tax bill.

Thinking about donating a collectible for the tax deduction? The IRS has two categories of collectible donations with very different tax treatments. If you donate your collectible to an institution that displays or specializes in that type of collectible, you can get a deduction for the appraised value of the item at the time of the donation. (Good luck getting the Museum of Fine Arts to take your "Dogs Playing Poker" masterpiece.) If, on the other hand, you donate your collectible to your church for an upcoming auction, you are only allowed to deduct the price that you paid for it.

When collectibles make sense

For the vast majority of prospective collectible investors, don't expect them to contribute meaningfully towards your retirement. The best reason for buying a collectible is because you enjoy looking at it and plan to keep it for a long time. Unless your assets exceed $10 million, or are a collectibles dealer, you're unlikely to have the financial resources to play in the collectibles marketplace with the expectation of making a significant profit. Once you start to deal in high-priced collectibles, say above $10,000, be prepared to filter out forgeries. (Even the experts can get fooled, as chronicled in Malcolm Gladwell's book *Blink*.) Unless you have significant expertise in this field, you should do your buying through reputable dealers. If you go that route, you will need to hold your purchase a very long time before you ever see a paper profit, if at all. Finally, don't forget to get an insurance rider to cover any expensive collectibles kept at home.

Displaying a collectible piece of artwork is a lot more pleasurable than holding 100 shares of Intel. Just don't expect the two to be equally profitable for you.

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