History and Development of the Fine Wine Investment Market.

The Hong Kong International Wine & Spirits Fair Trade Conference – 4.11.2009

By James Miles, Director of Liv-ex Ltd.

SLIDE 2 – Intro

Today, we have been given the task of outlining the history and development of the fine wine investment market. We are going to take a brief look at the history and summarise the vital role that speculation plays in the market place. We will give an overview of the market today and explain how independent wine critics and price transparency have transformed it. We look at both the compelling characteristics that fine wine enjoys as an investment and some structural weaknesses that hold the market back. To conclude we look at some of the lessons that the fine wine investment market might learn from more developed markets.

SLIDE 3 – The role of speculation

To most – quite rightly – wine is not about investment, it is about pleasure and, personally, I sit in the pleasure camp. Indeed, I have met very few people who are only interested in wine from an investment perspective. Nevertheless, investment and speculation in wine have always played an important role.

First, as in all markets, speculation adds to liquidity and is vital to the process of price discovery, helping to moderate imbalances in demand and supply.

Second, it allows growers to finance their crop, which for fine wine is often not ready for drinking for a decade or more. Holding 10 years worth of stock is clearly not a great business model! The prospect of profit motivates merchants, collectors and wine funds to buy fine wine long before it is ready to drink. This in turn allows producers the luxury of making wines with the capacity to age.

For collectors the investment element is also part of the appeal and the profits help many to subsidize an expensive pastime.

SLIDE 4 – A potted history

In a historical context the wine market makes mainstream investment markets, like equities and bonds, look positively nouveau. Wine production dates back some 6,500 years. Bordeaux has been producing wine for two millennia and the UK has been Bordeaux's largest export market for at least 900 years.

The first reference to a fine wine brand that we would recognise today can be found in the diaries of Samuel Pepys in 1663. At that time, he noted how he "drank a sort of French wine called Ho Bryen that hath a good and most particular taste I never met with". The great chateaux of Bordeaux – including Haut Brion – still dominate the fine wine investment landscape and account for about 90% of Liv-ex's turnover.

The wine investment market today looks increasingly mainstream. Private collectors in the UK alone hold more than US$2bn worth of fine wine in bonded warehouses, the Liv-ex membership is currently offering US$1.5bn for sale and professionally managed wine funds have invested some US$300m.

SLIDE 5 – Today's market

Liv-ex estimates that the fine wine market is worth US$3 billion annually – a figure that has trebled since 2004. Traditionally the market was concentrated in northern Europe, but with globalisation it has spread to the US, Japan, SE Asia and more recently to emerging economies like China and Russia. The Liv-ex membership (which includes merchants in 22 countries) accounts for about 75% of total market turnover between them and reflects the global nature of the marketplace today.

Hong Kong and China have been particularly important markets recently, accounting for 40-60% of the turnover for London's biggest merchants this year. This is reflected in Hong Kong's import numbers for still wine, which show imports from the UK alone growing 147% to US$80m in the first seven months of the year. In fact, the UK has overtaken France to become the SAR's largest supplier.

The auction market, despite dominating the headlines, constitutes only a tenth of this total at US$300m, two-thirds of which is accounted for by the auction-centric US market. Globally it is merchants that dominate.

In Europe, merchants account for 40 times more turnover than auctions (at US$2bn annually compared to US$50m). The two largest merchants in the UK alone traded more fine wine than was sold at auction in 2008. Given the laissez faire nature of Hong Kong, it is merchants that seem likely to dominate the market here too. This is not to detract from the fact that Hong Kong has overtaken London as an auction hub this year, which is a remarkable achievement in such a short time.

SLIDE 6 – How to define fine wine?

To be regarded as a fine wine, a wine must have the potential to both improve in bottle and appreciate in value, and be actively sought after in the secondary market. To satisfy this requirement, a wine must have a long track record (often centuries rather than decades) and have received strong critical acclaim (from Robert Parker in particular).

In practice, this is a narrow group of wines and includes the very top wines of Bordeaux and a smattering of wines from Burgundy, the Rhone, Italy, Champagne and the New World. Most professionally managed investment portfolios, for example, have between 80-90% by value invested in just eight brands – the five First Growths, plus Cheval Blanc, Petrus and Ausone. These brands have accounted for 64% of Liv-ex's turnover in 2009 (and Lafite Rothschild on the back of Chinese demand for 24%).

SLIDE 7 – Critics and transparency

For much of history, wine investment was the preserve of the European aristocracy, who had both the capital and space to bring wines to maturity. In recent decades, greater price transparency and the influence of wine critics has demystified and democratised fine wine, bringing it to the attention of a much larger audience.

This process started with the emergence of independent wine critics over the last few decades, such as Robert Parker, Stephen Tanzer, Jancis Robinson MW and the *Wine Spectator*. The critics act as independent arbiters of quality, giving consumers the confidence to make purchases without having to taste the wine. With many fine wines now costing hundreds, if not thousands, of dollars per bottle, this is crucial.

Access to pricing information has been similarly revolutionised since the advent of the internet. Price tracking and comparison websites, such as Liv-ex.com, have given everybody access to accurate, up-to-date price information on thousands of fine wines. This has made buying and selling much more transparent, increased confidence and precipitated strong growth.

SLIDE 8 – The power of Parker

Robert Parker, the publisher of the Wine Advocate *newsletter, remains the wine critic with the power to move the market. Here we show a chart of Lafite Rothschild 2008. His 98-100 point rating – released in April's edition of the Wine Advocate - surprised the market and resulted in a 75% price increase overnight.*

SLIDE 9 – Building transparency

Here is a quick example of the data available on just one page of Liv-ex: Live Bids & Offers, merchant offer prices, Liv-ex transactions, auction hammer prices, release prices and full price history. This information would have only been available to a limited number of insiders five years ago and is now available at the click of a mouse.

SLIDE 10 – A compelling investment case

The economic case for investing in wine is compelling: supply is static (increasingly quality conscious producers have even cut production in recent years). Moreover, fine wine cannot be replenished. Every time a bottle of Lafite-Rothschild 1982 is opened, there is one less for the world to enjoy. Add to this rising demand from new markets, like Asia, and the case for rising prices is a powerful one.

As the table in slide 10 shows, Wine has also been a useful tool for portfolio diversification with a history of high returns, low volatility and negligible correlation to mainstream assets. The Liv-ex Fine Wine Investables Index, for example, which tracks the price of notable Bordeaux wines, has achieved a compound annual return of 13% since 1988 – better than equities, gold and property.

SLIDE 11 - But it is no panacea

Fine wine, however, is no investment panacea. Investors should never lose sight of the fact that somebody has to drink the wine if current prices are to be justified or increase. Moreover, one shouldn't discount both the storage and opportunity costs of holding a commodity that generates no income.

Structural weaknesses in the supply chain and settlement infrastructure also contribute to low liquidity, high transaction costs and slow working capital cycle times. Private collectors face paying away 10-15% to their merchant or as much as 20% at auction. This is not because these middlemen are making super normal profits, but because volumes remain relatively low and the costs of doing business are high.

Central to the problem is the fact that every trade in the fine wine market has to be physically delivered in order to transfer ownership. This is inefficient and costly. The existing supply chain has been designed to handle fast-moving and low value wines. For a product that requires both long-term cellaring and commands prices of up to $50,000 per case, this is clearly not fit for purpose.

The "en primeur" system used by Bordeaux to sell its new vintage each year is also hampered by a high level of systemic risk in the supply chain and a lack of transparency. Both should be addressed.

SLIDE 12 – Some possible solutions

Fine wine could learn a lot from more established markets. A central depository of ownership, for example, similar to that used to record the registered owners of securities in the equities market, would allow for dematerialised trading of fine wine. By transferring title electronically fine wine could be left to age gracefully and a huge element of cost and risk would be removed.

We would also advocate more transparency in the en primeur system. Production figures and volumes offered for sale by the chateaux should be audited and published. Tasting samples should be independently verified, so that consumers can be confident that wines tasted en primeur will be a fair reflection of the bottled wine two years hence. Finally, a mechanism in Bordeaux similar to the central depository system described above would also allow ownership to be transferred prior to receipt of the goods. This would remove the systemic risk inherent in en primeur trading.

SLIDE 13 – Conclusion

To summarise, fine wine has long been a part of a rich man's portfolio. In the last 20 years, wine critics and price transparency have democratised the market and brought its benefits for both pleasure and investment to a much larger audience. We believe these trends are still in their infancy as new markets open up. Wine investment is no panacea, however, low liquidity and high costs are currently limiting factors. Nevertheless, if we can learn the lessons from more established markets and modernise fine wine's settlement infrastructure, we would free up huge capacity for additional growth and help the market fulfil its exciting potential.