The Fine Wine Investment Market – An Inside View

Hong Kong International Wine & Spirits Fair

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Slide 1: Intro

My name is James Miles, director and co-founder of Liv-ex.com – the global exchange for fine wine.

My role today is to set the scene. First I will provide some background on the market – what is fine wine investment and what makes fine wine investable? Then I will outline the current market situation and ask where the potential opportunities exist today.

Slide 2: What is Liv-ex?

Liv-ex operates a global trading platform for fine wine merchants. Our members come to us to check prices and find trading opportunities.

We also have a logistics business, called Vine, and sell price data and research to merchants and collectors.

Slide 3: A potted history

Fine wine has a long and distinguished history. 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.

Indeed, the famous chateaux – the brands –of Bordeaux have been around for centuries. The first recorded mention was by Samuel Pepys in his famous diaries 350 years ago. Here he eulogised about a bottle of Chateau Haut Brion that he had tasted for the first time.

More recent landmarks include the publication of Robert Parker’s *Wine Advocate,* 33 years ago, which helped demystify wine and bring it to a larger audience. And of course, in the last ten years, the internet and sites like Liv-ex.com, which have introduced transparency to a traditionally opaque market.

Crucially, for as long as wine has been produced, traded and consumed, it has also been invested in.

Slide 4: The role of speculation

Fundamentally, wine is for pleasure. I have met very few collectors who were only interested in investment. But investment and speculation have always played a crucial role.

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.

It also allows growers to finance their crop, which for fine wine is often not ready for drinking for a decade or more.

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.

In the last 20 years, fine wine investment has moved forward considerably – most notably with the increase in transparency – and is well on the way to becoming a credible asset class.

Slide 5: Today’s market

Today, the market is worth approximately US$4 billion per year. This represents a fourfold increase since 2004.

Globally, merchants dominate, accounting for 90% of this trade. The balance is auctions.

The rise of new markets – such as Hong Kong and China – has driven growth in recent years. Of the US$400 million of wine sold at auction in 2010, for example, some US$180 million, or 40%, was accounted for by Hong Kong alone. Many international merchants now do a similar portion of their business here.

Slide 6: How to define fine wine

What truly separates fine wine from commercial wine is strong demand on the secondary market.

Also important, is the ability to improve in bottle and a long track record of excellence. Critical opinion also plays a part. Traditionally, only wines that scored more than 90 points (from Robert Parker or his peers) were deemed to be worth buying.

From an investment perspective, we are talking about a surprisingly narrow universe of wines. The top 25 chateaux in Bordeaux and a handful of properties from other regions dominate. Indeed, our research suggests that just eight wines – the five First Growths, plus Petrus, Cheval Blanc and Ausone – account for more than 80% of a typical wine fund’s portfolio by value.

Moreover, Bordeaux accounted for 95% of Liv-ex exchange turnover in 2010, with the five First Growths taking 52% of trade by value.

Slide 7: Factors that influence price

As supply of fine wine is tightly controlled in France, production in the great estates has been flat to down over the last 20 years. This has been compounded by the fact that the chateaux have become more quality conscious. As such, changes in demand have been the main determinant of price.

The most important of these in recent years has been new markets, most notably China and Hong Kong. As such, it has been brands that are followed in these rapidly growing markets, like Lafite, that have seen the fastest price increases.

Also worth considering are:

Vintage quality – Historically, but not exclusively, it has been the best wines from the best vintages that have provided the best returns.

Critical opinion – particularly that of Robert Parker, has also been important.

And finally, economic conditions – A recent paper by the IMF demonstrated a close correlation between fine wine prices and emerging market industrial production.

Slide 8: Emerging market influence

This correlation can be clearly seen in this chart.

Slide 9: The investment case

This demand/ supply dynamic makes for a compelling investment case. The Liv-ex Fine Wine Investables Index has achieved a compound annual return of almost 15% over the last 20 years – better than any of the other so-called SWAGs, which stands for Silver, Wine, Art and Gold. (All of these collectibles have done well since 2008.)

Wine is also a useful tool for portfolio diversification, with a history of high returns and low volatility.

Slide 10: Best in class

You can see here that fine wine is best in class when compared to the SWAG group on measures of both volatility and return over 20 years, enjoying the lowest volatility and highest returns.

Slide 11: 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.

Moreover, the market isn’t regulated, so investors should approach fine wine investment with their eyes wide open and do their own research.

As we have shown, fine wine is also heavily exposed to emerging markets, which many will regard as being a risk as well as an opportunity.

Slide 12: A correction underway

So what’s happening in the marketplace today? Let’s have a look at some data.

As you can see, after three years of strong price increases the market is currently experiencing a correction and is down 15% in just four months.

This correction has many interconnected causes, such as sovereign debt worries, continued weakness in the global economy and, perhaps, a feeling that the fine wine market – particularly Lafite – was over extended.

Slide 13: Lafite drives the market up

Up until April of this year, the market rode on the back of China’s insatiable appetite for Lafite Rothschild. In the five years to mid-2011, the price of Lafite increased more than twice as fast as its First Growth peers.

Slide 14: And down

But Lafite has also led the market down. Some vintages have lost 25% of their value since July.

Slide 15: A buying opportunity?

With the market now down 15% from its peak, are we approaching an attractive entry point?

Studies of fine wine prices looking back 50 years have shown that, on average, fine wine has returned12.5% per annum. On this basis, the chart shows that we are not far off this long-run average, although it did overshoot this level in 2008.

While timing is always difficult, we remain optimistic about the market for many of the reasons we have highlighted. Nevertheless, we suspect that the next bull run is unlikely to be led by Lafite. Indeed, as the Chinese market becomes more sophisticated it seems inevitable that it will experiment with a broader range of wines.

Slide 16: Where next: The Magical 20

Next week Robert Parker is leading a tasting in Hong Kong, which he has dubbed“The Magical 20”. In his own words: “I have chosen estates that produce wines of ‘First Growth quality’ although technically not First Growths...and because of that are under-valued and very smart acquisitions."

Many of these so-called Magical 20 wines– such as Leoville Las Cases, Lynch Bages and Pontet Canet – have seen a significant uptick in demand in 2011 and it is possible that this trend could continue.

Here we have created an index of the these 20 wines and compared their performance to the Liv-ex Fine Wine 50, which is exclusively composed of First Growths. As you can see, the Fine Wine 50 has vastly outperformed the Magical 20 over a five-year period, but this gap has narrowed recently. Indeed, given that the Magical 20 wines trade at an average 85% discount to the First Growths, Parker seems to be right in suggesting that there is plenty of relative value in these wines. A narrowing of the discount to say 70% could see these wines double in price.

Slide 17: A further broadening: DRC

This chart of the wines of Domaine Romanee Conti (DRC) – Burgundy’s most famous estate – is further evidence that the market may be getting deeper. As you can see from the chart, weakness in Bordeaux has had no impact on DRC prices so far.

Slide 18: Conclusion

So in summary, fine wine is fast establishing itself as a credible alternative asset class.The fate of the market seems likely to remain closely aligned to changing tastes in China and other emerging markets. As such, Lafite may not lead the recovery, when it arrives, but wines such as the Magical 20 and those from outside Bordeaux do seem likely to benefit as demand deepens and the market becomes more sophisticated. Thank you.