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Rembrandt's & Perception

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Why do people sometimes spend lavish amounts of money on pieces of art? It could be for purely personal reasons; they like the painter. It could be for aesthetic reasons; they like the painting. It could also be for financial reasons; they believe it can be sold at a higher price in the near future.

The Dutch painter, Rembrandt, is considered to be one of the greatest visual artists of all time. The price of a Rembrandt is often decoupled from any ‘rational’ estimate of its underlying value. What is a Rembrandt intrinsically worth? Who knows. It is worth whatever a willing and able buyer is prepared to spend.

However, what happens to an otherwise unknown painting that is suddenly ‘discovered’ to have been painted by Rembrandt himself? This happened in 2016 when an art dealer bought a painting at a Christie’s Auction for £137,000 and was subsequently valued at £10 million in 2018 after the true identity of the painter was revealed. This is equivalent to an annualised return of about 700%.

What changed in this period to cause such a dramatic increase in price? The brush strokes on the painting hadn’t changed, neither had the canvas which it was painted on. What changed was people’s perception of the painting. It had morphed from an unknown painting to a Rembrandt and its valuation rose dramatically to reflect this.

In equity markets, returns are achieved through two ways – multiple expansion or improved performance of the underlying company. Multiple expansion occurs when people place a larger premium on a company’s future profit. Nothing has fundamentally changed about the company, but people believe its future will be much better than anticipated so are willing to pay a higher price to buy shares in the company. Similar to the example of the Rembrandt painting, a change in people’s perception can lead to a multiple expansion and higher returns.

Three years ago, our strategies at Tacit had a larger exposure to ‘Rembrandt’ type stocks. These are companies whose returns largely came from multiple expansion. However, with prices where they are in certain equity markets, there is an increased risk of multiple contraction. Back to our Rembrandt painting example – what would happen if the authenticity of the Rembrandt was called into question? After all, it was authenticated by a single scholar and such evaluation can often be subjective. If the price was to fall from £10 million down to £1 million, anyone who bought the painting for £10 million would have experienced a loss of 90%.

At Tacit, we attempt to reduce the risk of multiple contraction at this stage of the market cycle by limiting our exposure to equities with excessively high valuations.

2000. Please note, tax and estate planning services are not regulated by the FCA.