Uncorrelated Returns from Fiddling (While the Market Burns?)

By Martin de Sa'Pinto, Senior Financial Correspondent | Friday, December 14, 2007

'Bring on the violins' may be a typical, though tongue-in-cheek response to many hard-luck stories. But for some investors at least, these much-loved instruments may be a source of healthy returns.

At times of market stress the search for uncorrelated sources of return begins to feel more than ever like the quest for the Holy Grail. With problems in mortgage-backed securities causing jitters in the broader market, asset-backed commercial paper liquidity drying up and growing concerns about crowded trades, emerging markets hype and many asset classes reacting in lockstep to each new tremor, it has been a difficult year for many investors.

When crisis hits, correlations between even what appear to be totally unrelated asset classes may converge sharply, especially if there is forced selling as investors seek to de-leverage and to scrape together what liquidity they can. If they are selling into illiquid markets, then bid-offer spreads quickly can take on chasm-like qualities. This is one of the main reasons that vehicles such as private equity or event-driven funds, which often invest in illiquid instruments, will use lock-ups—they are trying to ensure that in difficult periods, a tide of redemption requests cannot push the fund into a series of unprofitable transactions.

For their part, investors are keen to diversify, and those wishing to access uncorrelated asset classes are often willing to put up with lock-ups, on the understanding that the less correlated the asset class, the less liquid the market might be. Initially, many emerging markets funds were offered with lock-up periods, but these have tended to become less common as a large number of these markets have become more liquid and lock-ups, consequently, less justifiable.

Cue Violins

Investors expecting turbulent market conditions to prevail in the coming period may wish to take a closer look at the Fine Violins Fund. It was launched in August 2007 by world-renowned stringed instrument expert Florian Leonhard, who has 25 years of experience in the field and specializes in the authentication, valuation and restoration of fine violins, cellos and violas.

The target asset class—fine violins and, to a lesser extent, cellos—can with justification be considered an uncorrelated asset class. The global market of fine string instruments is estimated at $11 billion and, according to the fund prospectus, has yielded compound annual returns of 12.8% since 1950, with volatility of just 6.1%. "Historically, this is a similar return to public equities, but for approximately half the risk," says Mr. Leonhard. In that period, the annual growth of the market has ranged between 7% and 15%.

Mr. Leonhard attributes the continued strong performance of the asset class to structural imbalances in the market. First, there is a broadening demand base, including a growing pool of emerging market musicians, high-net-worth investors attracted to the consistent returns and apparently limited downside and museums. Just as important is that supply is fixed and non-renewable. Specifically, notes the prospectus, "fine violins were crafted from rare ancient wood and treated with a particular varnish resulting in unique sound and playing characteristics; [the] craftsmanship of Italian 17th-18th century masters is unrivalled by modern violin makers; [and] acoustic characteristics improve over time as the instruments are played."

Mr. Leonhard's own background is steeped in the arts. His mother was a violinist, and his father was a painter. He himself began painting and sculpting at a very young age, and he also practiced ballet and still plays the cello. "I actually began playing the cello when I was nine years old, and have loved the instrument ever since, but I am not a performer," he admits. "I really wanted to play the double bass, but I was too small for that."

Then, 25 years ago, he began his career at world-renowned violin dealership and restoration house W.E. Hill & Sons, working his way up to head restorer. "First I started as a violin maker; then I studied as a restorer, moving on to world leading names," he tells HedgeWorld. In 1995, when he had already been collecting pieces for two years, he set up his own business, Florian Leonhard Fine Violins, which buys, authenticates, restores, values and re-sells fine string instruments. He is co-founder and treasurer of the British Violin Making Association, author of a number of publications on violin making, and special adviser to the London Symphony Orchestra and the Israel Philharmonic Orchestra.

"You can't really learn expertise in this field at a university, but only through working with the experts who are prepared to hand down that expertise," says Mr. Leonhard. "In violins, there are only a handful of experts worldwide at the top end. They understand the history of these instruments, what musicians have achieved with them in the past, and how valuable they might be." When you are a renowned expert in the field, he notes, those with a passion for the industry want to study with you. "There are 10 people in my workshop, all specializing in different fields," he says.

"Obviously, I've always had an entrepreneurial side, and am proud to have founded what is recognized as one of the world's most successful violin dealerships," continues Mr. Leonhard. "The idea to launch a fund was formed about seven years ago, since when I have worked closely with bankers and others to learn about the world of asset management."

The management team and board present a strong lineup of industry experts, asset management experience and political clout. The chairman, the viscount St. Davids, is a former deputy speaker of the U.K. parliament's upper chamber, the House of Lords. Mr. Leonhard's co-chief executive, Christopher Reuning, is based in Boston. Mr. Reuning has 30 years' experience in the authentication, valuation and restoration of stringed instruments, having founded dealership and restoration house Reuning & Son Violins with his parents in the 1970s. Business Development Director François Mann Quirici is a partner at financial and strategy consultancy Nexus Associates, and was previously an associate director in mergers and acquisitions at Lazard Frères, as well as an investment manager at $300 million private equity fund Platina.

The board members are well-known classical musician Julian Lloyd Webber; Michael Hoffman, co-founder of 1.5 billion euro ($2.2 billion) private equity fund Palamon Capital Partners; Sir Curtis Price, principal of the Royal Academy of Music in London; and Oxford University historian and philosopher Theodore Zeldin.

Fiddling: The Expenses

Mr. Leonhard is looking to raise around $80 million for the Fine Violins Fund. In August 2007, the fund received a commitment of 10 million euro ($14.7 million) in seeding from a large, U.K.-based family office. Mr. Leonhard, who will invest $1 million of his own, will build a portfolio of instruments valued at between $750,000 and $2.5 million apiece. An important stipulation of the prospectus is that fund partners and their affiliates will be disallowed from dealing in instruments whose values exceed $750,000 until the fund is fully invested. This is to avoid potential conflicts of interest between partners and the fund.

The Fine Violins Fund will have offices in London and in Boston, and will invest primarily in pre-19th century string instruments of Italian origin, according to Mr. Leonhard. The target allocation is

90% violins and 10% cellos. "If the fund has 40 to 50 instruments, there will be no danger of flooding the market, since we can liquidate our investments in an orderly fashion

Targeted returns are around 15% per annum after fees and expenses and volatility of around 5%, which Mr. Leonhard says is very much in line with historic performance. The fund also offers the opportunity for individual investors to leverage their holdings. The founding partners have built a track record since 1999, generating average annual returns of 25.1% and conducting around 500 transactions in that time.

The fee structure is typical of the private equity model. There will be an annual management fee of 2%, which reduces to 1% once the fund is fully invested. There is a performance fee of 20% for returns above an 8% hurdle, which is subject to catch-up payment by the general partner. Insurance, which will be provided by specialist firm Lark Group Ltd., will not represent a heavy drag on performance, since typical premiums are in the region of 0.1% to 0.2%, notes Mr. Leonhard.

While there is no direct benchmark, the objective is to outperform the General Art Index (compiled by Art Market Research) over a medium-term horizon. Investments will primarily be made in the first three years, and there will be no redemptions. Rather, cash distributions will be made from the end of year four onward through the life of the fund.

Fine Violins is domiciled in the Cayman Islands, though the investment adviser—Florian Leonhard Ltd.—will be based in the United Kingdom. The Royal Academy of Music will retain custody of the instruments. This arrangement will be supervised by Sir Price. The legal adviser is SJ Berwin LLP, the bankers are Coutts & Co. and the auditor is KPMG.

There are philanthropic aims, too. The fund will allow instruments in its possession to be loaned to developing musicians in order to help them launch their careers. Notes the prospectus, such an arrangement will optimize the quality of classical performance at the highest level. Furthermore, it says, "as provenance is a key price determinant, the value of violins also increases when loaned to leading musicians." As part of the arrangement, these musicians will be invited to perform privately for investors who have committed more than 1 million pounds to the fund and their guests, at a venue chosen by the investors themselves.

An investment and a concrete philanthropic endeavor rolled into one, indeed. "Great and promising players, who will be identified by a panel of leading soloists, will benefit for several years by being able to play the instruments while they are held by the fund," says Mr. Leonhard. "The advantage is reciprocal, because these instruments—which all have a history and a pedigree—will be heard more broadly, and there will be recordings." To illustrate, Mr. Leonhard says having one of the fund's pieces played by a budding virtuoso is almost the equivalent of saying John Lennon played on a certain guitar. "It would enhance its value significantly."

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