EnterpriseUK
The Financial Ecosystem

More truths about WINE INVESTING

How to appreciate your assets

CONTENTS

FOREWORD

This report together with others in the series is intended as a guide for investors interested in exploring the Fine Wine investment market and to provide periodic updates and commentary on this interesting and unique market.

Fine Wine continues to be an extremely attractive investment for savvy investors offering low volatility, steady long-term returns and very low correlation with other asset classes. This unique asset class has other features that further add to its appeal as a component of an alternative asset portfolio.

One such feature is that a significant proportion of wines that are purchased as an investment actually end up being consumed, thereby reducing the supply and maintaining prices for the most sought-after vintages.

Also, during 2016 the political and economic uncertainty surrounding Sterling meant that GBP based investors investing in overseas markets were generally better off on an unhedged basis, as this gave them both the underlying asset return in local currency terms plus the local currency appreciation against the pound. The reverse was generally true for overseas investors in GBP denominated assets where a hedged investment would have been superior.

However, within this market environment, fine wine enjoyed a significant boost. As a Sterling traded asset, it became cheaper for overseas investors who consequently bought more of it (as any true value investor should), thus driving up the prices. This price increase in turn also benefitted GBP based investors. The impact of post Brexit events on the fine wine market were reported in an article by Jillian Ambrose in The Telegraph of 1st January, 2017 titled “Fine wine index raises a toast to Brexit after biggest gains in six years”.

Finally, managers of fine wine funds and many wine traders often hold seminars and dedicated tasting events for their clients/investors, (such as the tasting and dinner held recently in central London by UKV PLC) providing opportunities for improving understanding and appreciation of the asset as well as networking with fellow investors.

I. INTRODUCTION TO WINE AS AN ASSET CLASS

Wine is a tangible asset and so has always been actively traded and collected. There is nothing new in the concept of wine prices increasing over time. Wine is a consumable asset and so is constantly diminishing in supply.

The asset class benefits from having a perfectly inverse supply curve. Fine wine tends to mature with age, and as it becomes older and more mature it becomes more desirable. For collectors, the fact that the prices of the finest wine have consistently risen over time adds to their appeal. New research has shown that more than one in four (27%) wealth managers and IFAs expect the appetite for wine investing to increase over the next 12 months as the impact of Brexit drives the sector to new highs and fuels demand for asset class diversification.

Nearly half (48%) of intermediaries highlighted the main reason for anticipating this increase was because fine wine acts as a diversifier to mainstream assets such as equities and bonds. More than two in five (43%) said it was because of attractive medium to long term returns. For example, since 1988 the compounded annual return for the most 'investable' wines in the market has been 11%. The same number of IFA/intermediaries (43%) cited the popularity of owning tangible assets while 33% said it was because of wine's low correlation with mainstream asset classes.

Chart 1, below, shows a comparison of the growth rates of the prices of different asset classes over the two years between December 2014 and January 2017, compared against the Liv-ex Fine Wine 100 index, an industry recognized benchmark index of fine wine prices.

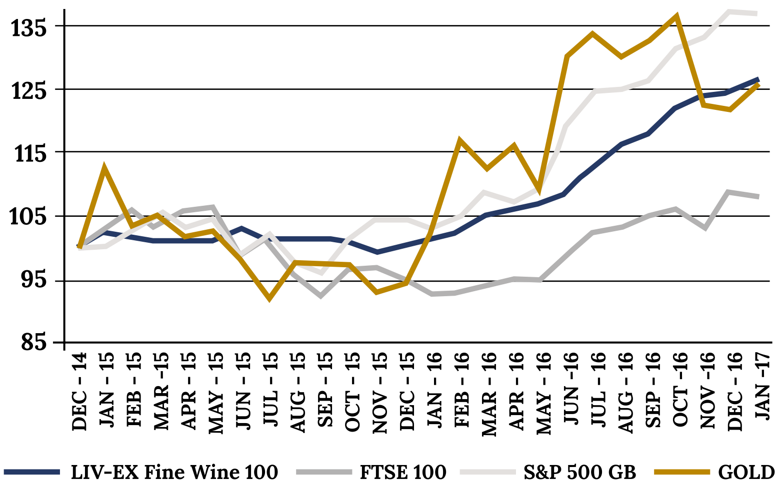

Chart 1. Comparison of asset class price indices
(all in GBP, rebased to Dec'14 = 100)
Source: Sources: Liv-ex, Google finance, Yahoo finance

II. WHICH WINES ARE THE MOST INVESTABLE?

The wines which have shown the strongest price appreciation and are deemed most attractive to collectors are those which are considered “fine wines”.

Taste is subjective, so there needs to be a recognised way of determining the quality of a wine. Over recent years, Robert Parker introduced a 100-point rating system – wines which score 96-100 are considered extraordinary – so profound and complex in character that they display all the attributes expected of a classic wine of its variety. Wines of this calibre are considered to be the best around and are the most collectible.

In the last few years the performance of the Liv-ex Fine Wine 50 Index and the Parker 100 Index has been quite closely correlated. Parker’s scores have significant influence on price performance and a score upgrade can cause prices to rise rapidly.

The wines most favoured by collectors are the prestigious Bordeaux vintages, which have generated impressive returns for investors, the prices of the best of which are tracked by the Liv-ex Bordeaux 500 index. Vintages from Burgundy have also performed well. The Super Tuscans have also become popular, as have some of the Australian Penfolds and American Screaming Eagle varieties, although the collectors market for these wines is a little more niche.

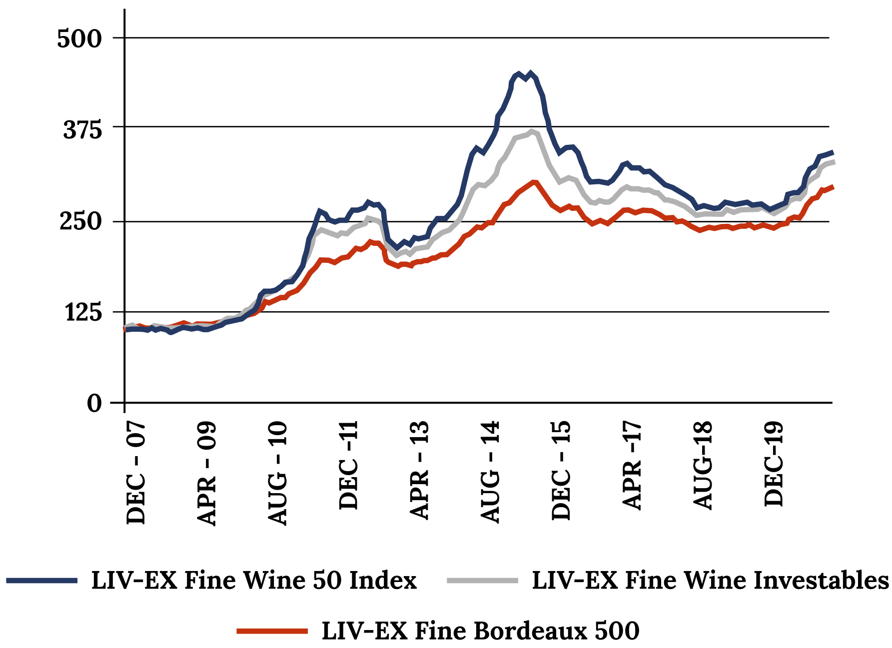

Chart 2. A comparison of leading fine wine indices

Source: liv-ex.com

III. WHAT FACTORS AFFECT PRICES?

A major factor to consider when looking for price growth is the appeal of a wine from a particular region to new and emerging markets – in the last few years the key influence on prices has been the level of demand from China.

In 2008 Hong Kong reduced the import duty to 0% and effectively became a “free wine port”.

This provided the catalyst for a period of 2-3 years of prolonged buying and demand from mainland China increased dramatically. Wine consumption from the other BRIC economies is also expected to rise although India and Brazil still levy restrictive import duty on European wines. As we noted above the value of the pound on the foreign exchange markets can also have a direct effect on overseas demand for wines with obvious consequences for their prices.

IV. HISTORICAL PERFORMANCE OF WINE INVESTMENTS

Compared with equities and virtually all other asset classes, wine has performed well. It is considered a safe, tangible and easily accessible asset class and an analysis of the Liv-ex Fine Wine Investable index data since 1988 showed the following in chart 3.

Chart 4 shows the amount of time when returns were positive, i.e. above 0%, and the level of returns achieved, for various 1, 2, 5 and 10-year investment holding periods. The chart shows that a “index weighted” portfolio of fine wines bought at any time between 1990 and 1995 and held without trading for 5 years would have generated returns between 100% and 350%.

The performance is further enhanced by the tax benefits which may be available to wine investors. Most wine is considered to be a wasting asset by HMRC, which means that profits may be exempt from Capital Gains Tax.

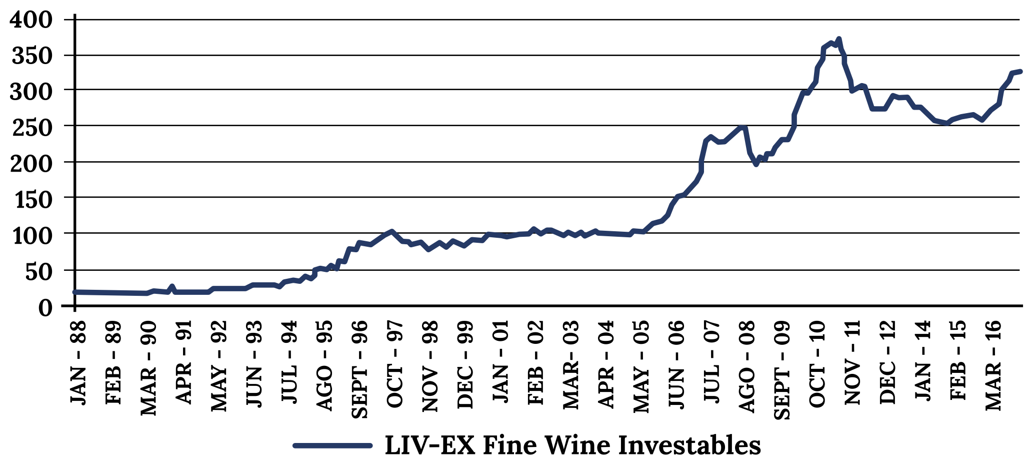

Chart 3. Liv-ex Fine wine investables

Source: liv-ex.com

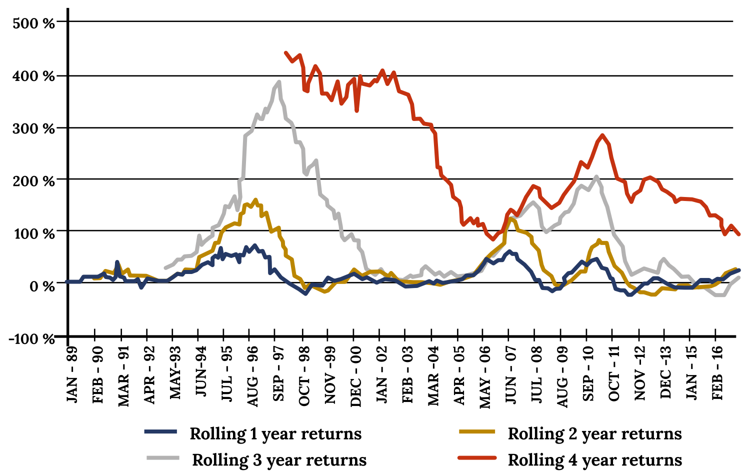

Chart 4. Chart of returns for the Liv-ex investables index over rolling periods of time.

Source: liv-ex.com

V. DIFFERENT INVESTMENT STRATEGIES

Inexperienced investors need to realise that not all wine will rise in value. 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, the top 25 chateaux in Bordeaux and a handful of properties from other regions dominate. Indeed, research suggests that just eight wines – the five First Growths, plus Petrus, Cheval Blanc and Ausone – account for more than 80 per cent of a typical wine fund's portfolio by value. Bordeaux wine accounts for the majority of turnover amongst collectors, although Burgundy, Italian, Australian and American wines are all becoming more collectable.

Fine wine, however, is no investment panacea. Investors should never lose sight of the fact that somebody must 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. Fine wine is also heavily exposed to emerging markets, which many will regard as being a risk as well as an opportunity.

There are three fundamental strategies for buying wine as an investment, and the suitability of each is determined by the level of experience of the investor:

WINE FUTURES

The terms wine futures and en primeur (literally 'in youth') refer to buying wine after it is made, but before it is bottled. Six months or so after vintage, when the wines are still in tank or barrel, tasting samples are made available to wholesale buyers and wine journalists. The buyers place orders based on their assessment of the wines, and sell their 'future' stock on to their customers (although the wine itself is not bottled and shipped for another year or two). The journalists rate the wines and publish their notes, in either print or online media. In the case of Bordeaux En Primeur, the wines are released in several stages or tranches, in which prices are adjusted up or down according to the success of the previous tranche. The first tranche typically attracts the most attention. Buying wine en primeur or as wine futures can be a prudent but risky investment practice – buying en primeur means committing to the wines at their youngest – with all the maturing to do, before the final blend and oak-ageing is complete, and is fraught with risk.

The actual bottled product may turn out better or worse than the initial barrel samples indicated. As a rule, do not buy en primeur in advance of the prices being published. And if you are going to have a dabble with these young wines, only do so with blue-chip merchants that have a good track record.

MANAGING YOUR OWN PORTFOLIO

The internet allows investors to search a multitude of sites when sourcing wine and in principal this should allow investors to shop around for the best bargains and add to their collections at the lowest possible prices. DIY investors also need to be aware of a growing incidence of fake wines circulating in the global market.

For obvious reasons, collectors should take the utmost care when buying trophy wines for investment, especially when the wines are offered at deep discount to published prices on sites such as e-bay. Provenance is all and wines with perfect provenance can command a significant premium. Another issue for DIY investors is the delivery and storage of the wines they buy. It is essential that wines are stored in the correct conditions. Wine is one of the few commodities that can improve with age, but it can also rapidly deteriorate if kept in inadequate conditions. The three factors that have the most direct impact on a wine's condition are light, humidity, and temperature. Strong light can adversely react with compounds in wine and create potential wine faults. Humidity is required to keep wines with cork enclosures from drying out.

Should the cork begin to dry out, it can allow oxygen to enter the bottle possibly causing the wine to spoil or oxidize. If the wine is exposed to too high a temperature (more than 77 °F/25 °C) for long periods of time, it may be spoiled or become "corked" and develop off-flavours.

In principal, DIY wine collecting sounds like a cheap way to access the market, but there are many pitfalls for the inexperienced investor operating solely on his own. Even if the bottles of wine bought are genuine, and the wine is stored correctly, it may be difficult to resell them at their full retail value since most serious investors buy and sell directly through their broker or wine merchant.

INVESTING VIA A BROKER

The traditional way to invest in wine is through a broker. This way the investor owns the underlying assets and has more control over what they invest in. A broker will help an investor build a portfolio tailored to the client's tastes based on the best offerings in the market. This will come at a cost, though; fees will vary according to the level of service and advice that the broker provides.

For an execution only service broker charges may be as much as 10 per cent at both the buying and selling stage. Some brokers build these premiums into the prices of their wines. If the broker is providing advice on which wines to buy and sell, this will also affect the level of premium. Some brokers also offer regular wine tastings to their clients as well as benefits such as visits to vineyards. These can be beneficial to investors as they add credibility and increase transparency, but both these services come at a cost. Investors should always ensure that the prices charged by their broker are competitive and reflective of the value of service provided.

When buying a precious asset such as fine wine – preferably in unmixed, sealed cases using original wood (OWC in trade-speak) – it is of paramount importance to ensure your bottles are stored professionally and correctly, in the right conditions. In doing so, you will help guarantee the future value of the wine when you come to sell.

Wine brokers understand that the best way to prove unquestionable provenance is to store fine wine in wooden cases 'in bond' (IB), which means in a bonded, 'duty-paid' warehouse such as London City Bond or Octavian Vaults. These bonded warehouses provide the optimum environment for storage, with the temperature, humidity and other microclimatic factors carefully regulated.

Wines stored in bond are not liable for Value Added Tax or UK excise duty as they are considered 'in transit'. In fact, a case of IB wine may change hands multiple times without ever leaving the bonded warehouse, removing the risk of damage and disruption. (Being IB also stops the temptation to pull a cork at the end of a jolly evening!) Only when the wine is removed from bond are these taxes paid. Also, a note on insurance: accidents happen – assets may be damaged or stolen. It's important that you insure your stock in your own name and at replacement value. It's vital you know who has custody of your assets – there is nothing safer than your own, fully-insured account in a bonded warehouse. If you do use a broker then make sure a genuine custodian is looking after both your cash and your stock.

VI. OVERVIEW OF CURRENT MARKET

After a lack lustre few years, which saw the Fine Wine Index drop from an all-time high of 448.38 (June 2011) to a 5 year low of 261.37 (November 2015), there has been a strong bounce back in recent months to a January 2017 level of 338.91, as the graph below shows.

Several individual wines have recently registered all-time highs on the Fine Wine Index and momentum remains strong. The strength of prices (£) may in part be attributable to the drop in value of Sterling against the Euro - On 23rd June 2016, the day of the Brexit vote, consumers could exchange their pounds for approximately 1.29 Euros - six months earlier the rate was 1.36 and six months later (31st December 2016) the rate was 1.16. A large percentage of fine wine collectors concentrate on vintages from European wine producing regions such as Bordeaux, Burgundy and Italy, and so the relative weakness of Sterling has meant that the GBP amounts paid to the euro based growers/producers has risen sharply.

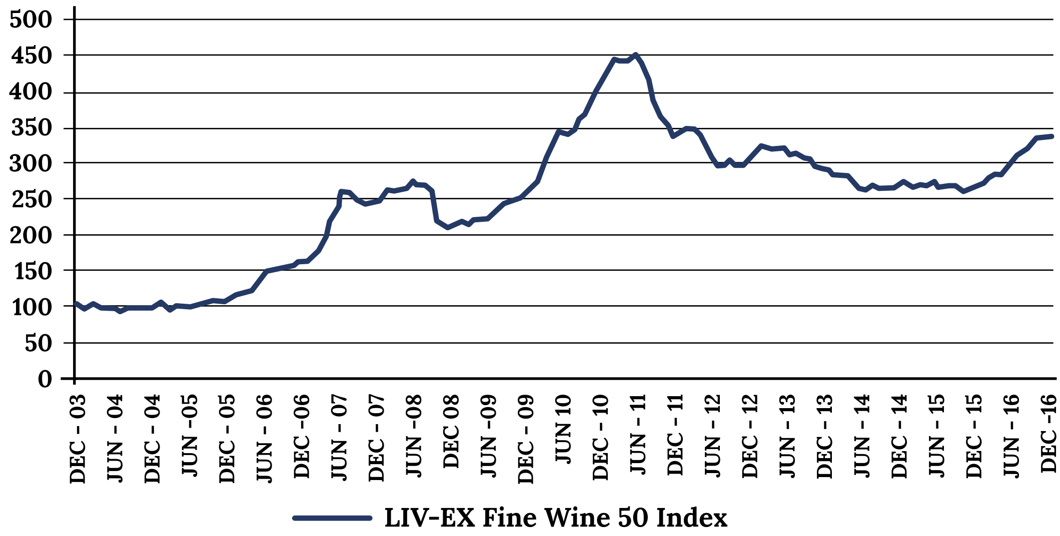

Chart 5. LIV EX Fine wine 50 index

Source: liv-ex.com

VII. THE PITFALLS AND WHAT TO AVOID

Wine as an investment does have some concerns, including the fact that (unlike dividend-paying stocks and bonds) stored wine produces no return for the investor until it is sold, plus insurance and storage costs will mean the investor is losing money while waiting for the wine's value to appreciate.

Investment in fine wine has attracted fraudsters who prey on their victims' ignorance of this sector of the wine market. Losses by investors to rogue wine investment firms can be significant, made more acute by the fraudsters willing to re-offend. Wine fraud often works by charging excessively high prices for off-vintage or lower-status wines from famous wine regions, while claiming that it is a sound investment unaffected by economic cycles. Efforts made by regulators to stem losses to rogue investment firms include the closing down of companies in the public interest.

Doing your research and finding the right merchant are the cornerstones of avoiding a bogus wine investment scam. Just as you would with a fund manager or stock, you need to research your wine merchant and check their history. This is especially important if you are considering putting money into en primeur. The wine equivalent of financial futures, en primeur is a method of buying up stock that is still in the barrel. This allows the investor to purchase wine at a cheaper price. However, you have no guarantee that the wine will retain its value when it comes to be bottled.

Investments are regulated in the UK by the Financial Conduct Authority (FCA). Unfortunately, few alternative investments, unless they are judged to be collective investments, come under the remit of the FCA. Companies selling cases of wine are not regulated, so always do your due diligence prior to investing.

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Contact us

+44 (0) 203 858 0024

info@enterpriseuk.co.uk

www.enterpriseuk.co.uk