WHITEPAPER

Colored Diamonds: A Rock-Solid Alternative Investment

Abstract: Wealthy investors and financial institutions around the globe have cause to be concerned about the safety of their financial assets, as the leading G8 central banks race to maintain whilst adding ever increasing liquidity into the system – which does little to cure the more critical issue, namely the sovereign solvency problem (a.k.a. the sovereign debt crisis). What we are facing is not a liquidity issue, it's a solvency problem.

As a result, most nations increasingly have begun to look upon "the people's financial assets" as economic property of the state: Cyprus is the most recent country to toy with taxing wealthy depositors. Germany and the European Central Bank have been aware of this option, and Swiss banking regulators considered "just taking money out of client accounts" two years ago, to save the Swiss banking system.

In a world where financial assets could conceivably be confiscated, the ultimate insurance play is in real assets: precious metals, real estate, land and diamonds, to name a few. This white paper explores the latter option—particularly colored diamonds, also known as "fancies"—which offer the most portable solution for investors seeking to diversify their real asset holdings and insure their wealth against potential future financial meltdowns and political upheaval.

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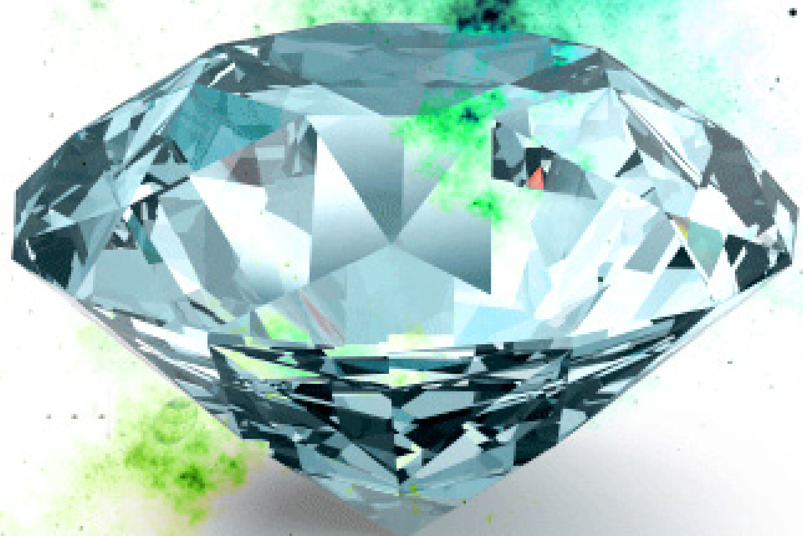

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FAMILY OFFICE ASSOCIATION

Supply and Demand

THE WHITE DIAMOND BUSINESS

Diamonds have long served as emblems of power and wealth. Since the 20th century, diamonds have also become tokens of romance and love, and found practical uses in industry. Diamonds also have taken on another function: as a source of investment.

Diamonds emerged relatively late in history. When first discovered in ancient riverbeds in India, people valued the shiny pebbles as good-luck talismans. The purer and more transparent the stone, the more luck, power and wealth it was thought to pack. Diamonds with yellow or brownish tinges were tossed back in the rivers. Today, the price of colored diamonds of comparable size, cut and quality, is much higher than the price of white diamonds. That's because there is a vast difference in the supply, demand and market mechanisms in white and colored diamonds:

The white diamond business has been growing almost systematically ever since the late 1800s—as if someone has been drawing the graph. That's because someone has been drawing the graph: the De Beers Mining Company. This South African firm, founded in 1880, has skillfully and gradually supplied the market with tenacious grace through its Central Selling Organization (CSO), a distribution cartel of producers mostly from Australia, Botswana, Zaire, South Africa and Russia.

The amount of raw (uncut or polished) stones mined and in storage vaults above ground is today several orders of magnitude greater than what has already been circulating in factories and jewelry stores or gracing individuals' fingers, necks, ears and wrists. However, CSO artificially constricts the supply when necessary and thus inflates prices by allowing producer members to sell only a set amount ten times a year. These producers sell take-it-or-leave-it packages of stones to the ever-increasing dealer demand, who are in turn encouraged to purchase the lots sight unseen, or risk losing the coveted privilege to participate in future sales.

On the demand side, the jewelry trade, industry and investors have fueled the appetite for white diamonds. As well, new wealth created in the past decade—especially in China, India and Russia—has fueled speculation of diamonds, adding to the inevitable upward price momentum.

Supply and Demand

THE WHITE DIAMOND BUSINESS *(cont'd)*

The diamond business came to a screeching halt in 2008, as banking scandals and mismanagement caused world economies to implode, but that was short-lived. Demand began to rebound in early to mid 2009. One reason: the economic crisis has motivated wealthy investors to seek protection from future financial fiascos with the help of alternative investments, particularly tangible assets such as precious metals and diamonds. Whilst always the case, diamonds are increasingly being accepted as a medium of exchange, store of wealth and a liquidity instrument around the world. Since late 2011, prices have flattened, but they remain above 2008 highs. Even as demand has dampened in the U.S., the growing middle class in China and India leads many experts to expect future appreciation.

However, that may be partially offset by some looming downward pricing pressure from at least two sources: First, Russian officials announced last September that a vast new cache of diamonds was buried under an asteroid crater at a secret site in Siberia, with billions of carats that could potentially meet global demand for hundreds, if not thousands, of years. These diamonds are “impact diamonds,” which are mostly for the industrial market because they are lower in quality than jewelry- or investment-grade stones. Because it is the hardest substance known, diamonds are used to cut, grind and polish most hard substances. Second, the market for artificially manufactured, flawless diamonds is expected to soar in the near future, as they become cheaper and cheaper to produce. About 60 percent of mined diamonds are used in industry each year, and seven times that amount (more than 570 million carats) are grown synthetically.

Supply and Demand

THE COLORED DIAMOND MARKET

The colored diamond market is much less organized than its physically transparent twin, with boutique and more distinctly recognized players in the U.S., Europe and Canada. In fact, until the mid 1950s, colored diamonds were largely ignored, and in some cases even discarded by white-diamonds miners. They are also much more rare. Miners find only one carat of colored diamonds, on average, for every 100,000 carats of white diamonds. That scarcity makes them pricey and enables them to better hold their unique and rare value. Colored diamonds, as a subset of the diamond market place, are unique and exclusive. Today, most fancies of comparable size, cut and clarity sell for a premium over white stones. In fact, prices of colored diamonds have historically enjoyed a strong and sustained straight-line up. One would do well to compare charts between the fiat currency debasement and the sustained, uninterrupted and systematic price increase in the colored diamonds marketplace.

The Many Facets of Hope

In the mid 1600s, King Louis X1V, the first known collector of diamonds, became obsessed with a 112-carat deep blue diamond that he purchased for 200,000 to 720 livres from a trader. He had the rock, probably from India, cut and mounted into a 67.125-carat cravat pin, which became known as the "Order of the Golden Fleece." He often wore this most prized possession as an emblem of his power and wealth.

This gem, known as the "Hope Diamond" ever since 1830, when wealthy British banker Thomas Hope purchased it for—depending on different sources—the equivalent of either $65,000 or $90,000. His bankrupt great grandson managed to sell the jewel for about $143,000 in 1901 to pay off debts. It has changed hands multiple times during the ensuing centuries, by sale or bequest, with prices fluctuating up and down, reaching $250,000 in 1884, down to $80,000 in 1908 to its most recent estimated value of $200 million to $250 million in 2011. The Hope Diamond was donated in 1958 to the Smithsonian Museum in Washington, D.C., where it can be viewed today.

Supply and Demand

THE COLORED DIAMOND MARKET *(cont'd)*

Each stone is truly one-of-a-kind. The color can be almost any color of the rainbow: the vast majority seem to come in brown and yellow; the rarest are blue, purple, green, ruby red and pure orange. Most come less than one carat, which adds even more value to larger colored diamonds.

The purchase of a colored diamond is an opportunity to store huge value into something small, undetectable and portable, and which will appreciate at an order of magnitude greater than the sustained increase in value of white diamonds. Unlike white diamonds, there is no way to flood the market with fancies or manipulate the price by controlling the release of diamonds depending on the supply/demand metrics. The colored diamond marketplace is far smaller than that of white diamonds.

Demand is constantly and steadily increasing as the marketplace grows, and supply has always been limited and very exclusive. Simple math suggests that systematic, increased growth in demand with marginal or negligible growth in supply would command a sustained higher price path. Even in an exceptionally tumultuous market, wholesale prices of white diamonds of various sizes have stabilized since the 2008 financial meltdown, except for gems four carats or larger, which did not rise or fall as much dramatically as smaller stones. Current prices of all sizes are higher today than in pre-crisis. In fact, in April, Christies, New York sold a 34.65-carat pink diamond, Princie, to an anonymous buyer for almost $40 million—the most a diamond has ever fetched in a U.S auction.

However, determining the quality and value of a particular colored diamond is as much an art as it is a science. Unlike white diamonds, colored diamond pricing is fairly subjective and complex—much like the art dealer market. The extra dimension of color and its many variations and variables of color defy efforts to standardize pricing. Also, the market is too small to allow for syndication or indexing as exist in the white diamond universe. Investors need access to specialized knowledge to ensure maximum precision when pricing a sale or purchase. It is critical to choose a good, reputable dealer who is willing to put his name behind the stone, given how many types of treatment exist to enhance and even modify the diamond's internals, flawlessness or integrity. In the least of cases, stones can be treated with heat—a practice often used by dealers to increase the color intensity. Other techniques also include injecting silicone into tiny fissures existent in the stones, which magically disappear only to reappear when receiving their first sonic heat cleaning. Honesty and reputation are critical when buying a colored diamond.

Alternative Investment

Whether one is sanguine or paranoid about the risk of global chaos, wealthy investors would be wise to devote a portion of their portfolio to colored diamonds.

Both white and colored diamonds hold the world's most concentrated form of wealth. It is possible, literally, to hold hundreds of millions of dollars of value in the palm of one's hand. In addition to a source of diversification and insurance against economic and political risk, they are portable and wearable. During World War II, many Eastern European Jews fleeing Nazis escaped with little or nothing but the clothes on their backs—with any jewels they could sew into the hems of their clothes. Once they arrived in a new country, they were able to sell their stones so they could eat, start a business or sponsor relatives still in the Old Country. Some Spanish families, even to this day, carry down the generational matriarchal line a tradition of gifting a twelve-stone bracelet to a newlywed, to ensure one stone per month might help sustain the family in times of need should ever they needed to flee and find themselves starting anew.

Today it's possible for those of means to do the same. Whether one is sanguine or paranoid about the risk of global chaos, wealthy investors would be wise to devote a portion of their portfolio to colored diamonds.

Allocation

Unlike tangible assets such as bullion, coins and other real assets, it's not necessary to keep gems safeguarded in home safes and bank vaults in several countries.

What would be a wise allocation, and what existing investments should diamonds replace? Ultra wealthy investors are generally advised to devote 10 to 30 percent of their portfolio into real assets as insurance against political and financial chaos. For instance, a billionaire who owns about $300 million worth of precious metals, art and real estate might choose to replace about a third or one half of that alternative investment allocation with diamonds. Of that, experts may recommend 30 percent in white diamonds and 70 percent in colored. Those who desire more liquidity might opt for a higher portion of white and less colored. Unlike tangible assets such as bullion, coins and other real assets, it's not necessary to keep gems safeguarded in home safes and bank vaults in several countries. The point is, gems can be made into jewelry that can be worn and carried anywhere, any time—with mutual consideration to the insurance carry costs and the disclosure of ownership to the open public—discretion may be wise. Also, loose stones can be kept in strong, bolted home safes in one's main residence and less in bank vaults, with the latter not discarded but less favored. After all, how would one get them in a crisis in which banks shut down entirely?

What about investing in diamond companies or diamond EFTs? There's nothing wrong with those avenues as investments, but they do not provide any insurance protection the way purchasing and taking delivery of real assets does. Therefore, in addition to purchasing real assets, our billionaire can allocate perhaps 5 to 15 percent of the $700 million left to invest—$35 million to $105 million—in a universe of public and private mining companies, EFTs, junior minors, private equity funds and hedge fund companies that participate in the white diamond and precious metals market. However, these options are not available with colored diamonds. Make no mistake about the critical differentiation between investing and insurance: the first is an alpha-seeking trade and the latter a hedge against government seizing property or a banking system failure.

Just as super wealthy families are wise to purchase their investments and insurance from different carriers in different countries (as described in FOA's white paper, "Global Citizen"), it's important to purchase real assets—especially colored diamonds—from a variety of different sources. Finding a very well-respected, reputable and recognized dealer evaluate the diamonds when getting them insured is also prudent, so the investor has a legitimate case if the gems are lost or stolen. These are the same measures by which one insures art, although this is not like insuring gold and silver, which is currency.

Caveat Emptor

It is crucial to find your own vetted, credentialed expert to advise and act upon your behalf both for buying or selling.

During the past few years, demand—and prices—of colored diamonds have been inflated by a stream of articles about record-breaking prices at high-profile auctions. The market is flooded with dozens of brokers, some of whom can be less than forthcoming about the quality or value of a given stone. Therefore, when navigating the colored diamond market, it is imperative to be as close to the heart and mind the market and its players.

It is crucial to find your own vetted, credentialed expert to advise and act upon your behalf both for buying or selling. There are two ways to go about this: You can go with a broker or a full-service operator. No two will sell you colored diamonds at the same price, for the same colored diamond, but it's not completely subjective. No two accountants will prepare the same return for a given client, but they all need to follow generally accepted accounting principles. Similarly, there agents and dealers need to abide by generally accepted pricing standards for colored diamonds.

It's not easy to find an agent who knows his stuff. Look for one who takes time to put research in front of his clients, and who is well connected. Also make sure your full-service agent can provide transfer pricing. The reason: If you're U.S. national with interests abroad, for instance, you need someone capable of transferring into dollars all income from your investments in every country, for tax purposes. Profits in Italy are not treated the same way as profits in Canada or Brazil. To consolidate all those profits derived from assets and income streams held overseas, you probably want a CPA with strong and deep transfer pricing expertise.

Whichever route one chooses, it is wise to have someone in your single family office who monitors colored diamond values for you. The family office CFO can be charged with calling the dealer every six months and keeping spread sheet of price changes, and can subscribe to the dealer's newsletter. Also make sure to get a yearly catalog of what hot new stones are available, and new styles of cuts and colors. It is absolutely crucial to obtain a certificate of authenticity once you purchase your stones, and let your agent know if you want your stones engraved with a serial number or not (see *Laser Engraving*).

There will continue to be speculation in diamonds as an investment vehicle, but you can improve your chances of winning by having the right advocate to advise you.

Laser Engraving

Lazare diamonds are all engraved. You don't see it; atomic size, if someone steals a gem and tries to erase the engraved serial number, the erasure can be seen. If someone tries to resell Lazare diamonds, you can see if someone has erased it.

The Four Cs: Carats, Clarity, Cut and Color

It also helps to know some basics, such as terminology and the variables that impact price. The "four Cs" below describe those variables: carats, clarity, cut and color:

CARATS: Each carat, which weighs one fifth of one gram, is divided into 100 points. A 75-point carat stone is therefore equal to three-fourths of a carat, or 0.75 ct.

CLARITY: A diamond's clarity is affected by *internal characteristics* and *surface features*. Internal characteristics include the number, nature, size, color and position of "inclusions" inside the gem, such as clouds, feathers, traces of crystals or mineral, knots, cavities, cleavage, bearding, internal graining, pinpoint and laser lines. Surface features are blemishes such as polish lines, grain boundaries, naturals, scratches, nicks, pits, chips or breaks. There are 11 grades of clarity: flawless and internally flawless are both called "pure;" VVS-1 and VVS-2 are considered "very, very small inclusions;" VS-1 and VS-2 are "very small inclusions," SI-1 and SI-2 are deemed "small inclusions;" while I-1, I-2 and I-3 are considered "included."

CUT: A stone's cut is not its shape but its symmetry, proportions and polish, which greatly impact its brilliance, or "fire." A diamond's cut is the most difficult trait for lay customers to judge because certificates don't often list key cut measurements such as the crown or pavilion angles, or don't reveal the appraiser's subjective ranking of the cut. Also, many professional groups—including Accredited Gem Appraisers (AGA), American Gem Society (AGS), Holloway Cut Advisor (HCA), and Gemological Institute of America (GIA)—have developed their own cut grading standards, and disagree on which are the best proportions. This is no trivial issue, as cut has a more profound affect on visual appearance (and hence, price) of a diamond than clarity—although color is quite important as well.

COLOR: The GIA has nine categories of shades, also called "fancy colors": Faint, Very Light, Light, Fancy Light, Fancy, Fancy Dark, Fancy Intense, Fancy Deep and Fancy Vivid. Colored diamonds are like snow flakes; no two are the same. Color grading factors in hue (overall color), tone (lightness or darkness) and saturation (color intensity). The more saturated the color, the higher the price of colored diamonds—which is just the opposite as white diamonds. Which colors are better? That depends on one's taste as well as current fads. Currently, red and blue stones command the highest prices per carat.

Conclusions

Colored diamonds offer more than an attractive investment, it also makes for stronger marital bonding!

- Because the market is not regulated, no one—not even the government—knows who owns what investors purchase (e.g. the buyer of the Princie pink diamond is anonymous)
- The market is small, but global, offering a reasonable degree of price stability.
- Unlike other luxury items that lose value, history shows colored diamonds have significant opportunity for appreciation.
- Because prices are not correlated with global financial markets, investing in fancies and other precious stones can serve as a hedge against the stock and bond markets.
- Portability makes it easy and to transport them anywhere.
- They carry significant aesthetic and emotional value.

On the down side:

- While liquidity is improving, it's not as liquid as other investments, such as stocks. Liquidity today is close to that of a real estate investment.
- They can be lost or stolen easily, so they must be insured and stored safely.
- To realize future gains, it's necessary to buy close to wholesale price.

Once an investor finds a vendor with the reputation, service and personality that fits the investor, it's not difficult to find a fair price.

Authors

Angelo J. Robles

Angelo J. Robles is the Founder and CEO of the Greenwich, Connecticut-based Family Office Association (FOA), a global membership organization that provides private educational and networking forums with top experts, plus thought leadership and proprietary research about and for multiple generations of wealthy families and the professionals who run their single family offices.

A member of the Princeton Council on Family Offices and the NYU Stern Family Office Council, Mr. Robles has a long track record of leadership positions at top financial service companies, including UBS. Before launching FOA, he engaged in several successful entrepreneurial ventures: He founded the New England chapter of the Hedge Fund Association (where he also served as president) and pioneered online retirement planning for Fortune 1000 executives with two Internet startups: 401KRollover.com and IRARollovers.com.

At FOA, Mr. Robles has spearheaded a series of provocative and groundbreaking Q&As with industry experts, and white papers that address the unique needs of ultra high net worth families in the U.S. and around the globe. These publications provide in-depth case studies of vibrant, multi-cultural single family offices as well as sophisticated approaches to wealth protection and growth, philanthropy, technology, social media, legal, tax, insurance and lifestyle concerns.

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