

# The Diamond Investment Promise: **Are Diamonds Finally A Commodity?**

By Edahn Golan





# THE INVESTMENT PROMISE

"INVESTMENT" IS THE WORD *DU JOUR* OF THE DIAMOND WORLD AND INVESTMENT IN DIAMONDS IS BECOMING A COMMON DISCUSSION IN FINANCIAL CIRCLES. AT THE SAME TIME, A GROWING NUMBER OF INITIATIVES ARE IN VARIOUS STAGES OF FORMATION.

**T**he wide range of formats and ways of investing reflect that this is a budding endeavor with the current initiatives testing new, mostly uncharted, ground.

At the heart of all of the offerings is the expectation that the price of diamonds, from 1 carat whites to high-end fancies, are set to increase steadily; some will appreciate slowly, beating inflation, while others are expected to appreciate by as much as 15 percent annually.

The expectation that the price of diamonds is set to increase is fueled by two factors: decreasing diamond reserves and increasing demand. The global diamond mining industry produces, on average, about 120-130 million carats of gem and industrial diamonds grade each year. Of this production, 28 million carats are gem and near-gem quality rough diamonds fit for the global jewelry industry.

This may seem like a plentiful supply, but diamond production is declining, down from the 168 million carats mined in 2007 and far below the +176 million carats per year mined prior to that. In addition, there is no certainty that the current quantity of production is sustainable.

With the exception of the Russian miner Alrosa – the world's largest producer by volume – all of the other diamond miners are decreasing production.

At the same time, the established diamond miners and many prospective miners are constantly exploring for new diamond sources. Currently there is no known high-quality, high-yield rich diamond source. Without any new mines coming online, the global diamond industry faces an increasing shortage of natural diamonds.



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## ARE DIAMONDS A COMMODITY?

While many along the diamond pipeline are brushing off the notion that diamonds are a commodity, they do so mainly because of how diamonds are sold to consumers : as a sign of love. The two, commodities and love, do not live well together under the same roof. Even so, all along the pipeline, until they reach the store, diamonds are treated as a commodity.

Polished diamonds are bought and sold based on parameters of weight, color, clarity and symmetry. Even the name of the lab that graded a diamond influences its price. These are all characteristics of trade in a commodity.

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It takes some 10 years from the discovery of a new resource to commercial production of a diamond mine. This means that if a new pipe was found today, it would take until at least 2022 for its production to be made available to the market.

In practical terms, there is no expectation that global diamond production will increase in the next 10 years – at best.

On the other side of the equation is demand. The leading consumer demand – by price point and growth – is bridal jewelry. In India, bridal jewelry is switching from gold to diamond jewelry; in China, diamond wedding rings are spreading from trend-setting Shanghai and Beijing to other urban areas; and in the U.S, bridal jewelry continues to be a must have.

GDP per capita, a reliable predictor of diamond jewelry demand, is set to grow, mainly in the BRIC countries – Brazil, Russia, India and China. These growing economies are witnessing more people becoming wealthy, and many more joining the middle class. With this new found financial ability comes growing discretionary income, which is being spent on luxury goods.

China and India posted a real GDP growth of 9.2 percent and 6.9 percent, respectively in 2011. The World Bank pins global GDP growth in 2011 of 2.7 percent.

While GDP growth is expected to slow down in 2012, China and India are expected to continue their above average growth and provide the two economic engines of the diamond industry. Global GDP growth is expected to slow to 2.5 percent in 2012, China's GDP is forecasted to grow by 8.2 percent, and in India GDP is projected to grow by 6.6 percent, according to the World Bank.

Aided by continued marketing efforts, this growth is fueling the increased demand in diamond jewelry.

In practical terms, there is no expectation that global diamond production will increase in the next 10 years – at best. If the current known resources start to dwindle, supply will contract.



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While supply is declining, global consumer demand for diamond jewelry is growing and shifting. If in the past more than 50 percent of global diamond jewelry consumption was in the U.S., today consumers from growing economies are buying diamond jewelry in increasing levels.

By 2015, China and India, together with Hong Kong, Taiwan and the Gulf countries are expected to consume about 40 percent of diamond jewelry globally, rising from the current 31 percent market share.

Demand for diamond jewelry in China and India increased by an estimated 10 percent and 9 percent respectively in 2010 and by another 9 percent and 8 percent in 2011. This year the forecast is for continued steady growth, the same as in 2011.

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The forecasted rise in consumer demand, taking place when supply will be steady at best and more likely declining, is expected to provide the backdrop to rising diamond prices in the consumer markets and prompt rising prices in years to come.

There are two main diamond categories investors are taking note of in particular: high-end diamonds and “bread and butter” white goods.

The first category is comprised of fancy color diamonds, mainly those with VS clarities and better, preferably with at least a “Fancy” color grading. Fancy color diamonds that have only one color without a secondary color (pink



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vs purplish pink, for example) are preferred. This category also includes diamonds larger than 10 carats, with a DEF color and FL-VVS clarity.

This category is not a new venue for investment. However, with the growing understanding of the potential diamonds have as an investment venue, more people are interested in investing than ever before.

The second category of goods is often referred to as “standard,” “ABC” or “bread and butter” goods. Broadly defined, these goods consist of 1 carat, D-J color, IF-SI1, round GIA certified diamonds. Some investment companies are looking at a broader range of size, ranging from 0.50 carats to 3 carats.

## A COLLAPSE PAVES THE ROAD

The event that fueled this swell of investment projects was the 2008 financial collapse that crushed the value of many investors' savings, and the fall of a number of leading financial institutions. During the downturn, the value of shares on the stock markets dropped, housing and real estate prices – mired by an over-reliance on poorly offered mortgages – declined sharply, commodities traded around the world and used by industries and consumers in a variety of applications fell out of favor and the lost demand brought prices sharply down. Investors saw the value of their portfolios plummet.

In response, many investors started seeking ways to add a component to their portfolios that would remain stable in times of economic calamity, an element that at the very least would protect some of the portfolio and remain liquid. The desire was that such a component would provide an option to put cash in the hand of an investor without – or at least hardly without – loss to the value of saved capital.

This, of course, is the very minimum requirement. Ideally – just as with any other investment – appreciation is desirable.

As prices of colored diamonds at auctions kept grabbing attention, financial institutes and wealth managers started considering diamonds as the possible missing component they were seeking. Simultaneously, diamond traders realized that their precious gems performed better than most other investments during the financial crisis. Thus, the initial ideas of investing in diamonds started to come alive.

Consequently, it was not long before these two groups – sometimes jointly – started looking for ways to commoditize diamonds, something that had happened a few times before, but never to the extent of diamonds becoming a bona fide commodity akin to precious metals, wheat and coffee.



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## WHY NOW?

The 2008 crash was an unusually deep one, but not the only recession or difficult economic period in recent memory. Other changes have made this a particularly attractive time for investing in diamonds. In particular, there are four specific changes that are taking place in the diamond sector.

First, until recently, De Beers was the monopolistic supplier of rough diamonds to the world. Its rough pricing policies had a great influence on polished prices. The firm sought to maintain prices by regulating the availability of rough diamonds. To do so, it held on to a very large stock of rough diamonds, worth an estimated \$5 billion, well above





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the value of its annual sales. By deciding what to offer and when, it could maintain prices in the market – not completely, but enough to raise worries in the investment community that one player could easily effect prices.

The decline of De Beers' market share from +80 percent to about 38 percent today, with the addition of selling off its huge inventory to leave it with a working inventory of a few hundred million dollars, removes this issue.

In this process, De Beers also lost its marketing contracts with other large diamond miners, such as Alrosa, giving other firms a stab at rising – or declining prices – as the market demanded.

Today there are a number of large diamond miners: Alrosa, BHP Billiton and Rio Tinto, as well as several mid-sized companies such as Petra and Gem Diamonds. All of them market their rough diamonds independently, via tenders, contracted selling agreements and one off sales, resulting in a wide range of prices, leading to a shift from a supply-driven market to a demand-driven market.

The second reason is a lack of pricing transparency. An open trading market is not possible without knowing the price at which polished diamonds are sold. The rise of platforms such as IDEX Online and a number of other such operations are changing this, bringing transparency to the market. Today price discovery of polished diamonds is much easier, allowing traders to have a better understanding of the price at which a diamond is sold.

This price discovery is a fundamental requirement for investment. Without knowing the price, investors cannot assess an investment or make an informed decision about buying or selling. Great efforts are being made by the burgeoning diamond investment entities to provide price information in a transparent and objective way.

A third issue is the need for a marketplace open to the financial community, a place where diamonds can be bought and sold easily – and at market prices. This, just like transparent pricing, is now readily available.

Some of the new entities are forming their own platforms where investors will be able to buy and sell diamonds. Others intend to employ a more traditional method, using experienced buyers who will facilitate the transactions.

However, while using a buyer is a good option in many instances, the real need is for an automatic platform where buying and selling is quick, efficient and trackable (See details on the Guaranteed Diamond Transactions™ (GDT™) spot market platform for an example of such trading arena on page 106).

Finally, because of the aforementioned three reasons, the investment community has been reluctant to enter into diamond investments. With the growing fragmentation of the mining sector, the availability of transparent pricing and the creation of a trading platform, these barriers are being removed, creating new opportunities for the financial sector to invest in diamonds.



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# BREAD AND BUTTER

THE MANY INITIATIVES FORMING TODAY OFFER A COUPLE OF DIFFERENT WAYS OF INVESTING IN DIAMONDS. IN ADDITION, THEY DIFFER IN THE TYPE OF GOODS ON WHICH THEY ARE FOCUSING. SOME INVESTORS ARE LOOKING AT HIGH-END DIAMONDS – FANCY COLOR DIAMONDS AND VERY LARGE DIAMONDS – WHILE OTHERS ARE FOCUSING ON “BREAD AND BUTTER” ITEMS, MAINLY 1 CARAT WHITE GOODS.

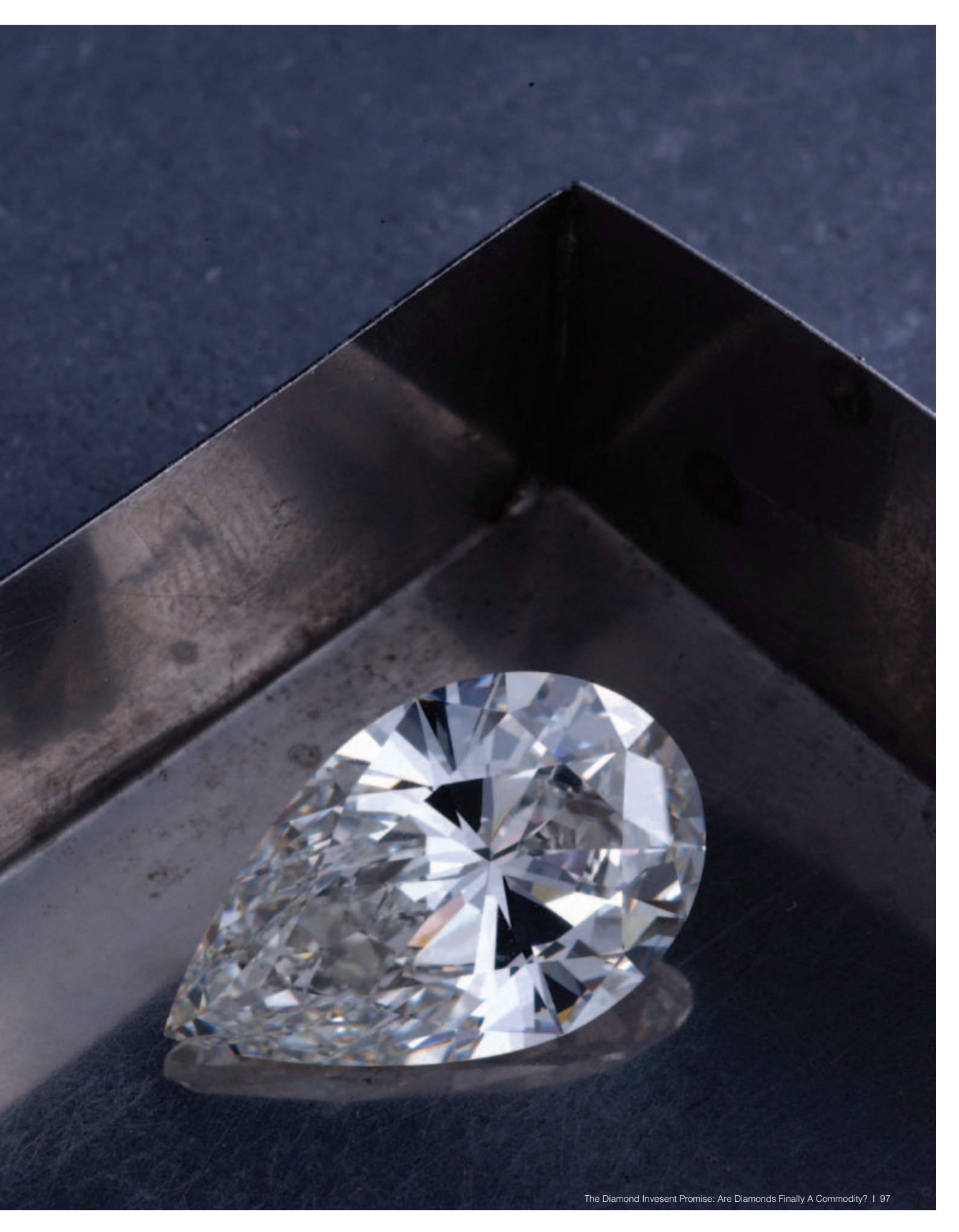
**T**he idea of investing in 1 carat white diamonds is not new. The Thomson McKinnon Diamond Investment Trust, formed in March 1981, was offering investors the chance to profit from skyrocketing polished prices some 30 years ago. Unfortunately, the fund’s timing was terrible. Mushrooming prices were unsustainable and started falling shortly before the fund started trading (see Thomson McKinnon Diamond Investment Trust, *The Infamous Forerunner*, page 118).


More recently, the attention of the global financial press has shifted once again to investment in 1 carat white diamonds when the New York-based investment house IndexIQ suggested in an S-1 filing with the Securities and Exchange Commission, issuing shares in a diamond-backed fund: The IQ Physical Diamond Trust.

The fund’s shares will be sold to the public at prices determined by the price of 1 carat, investment grade and GIA-certified round diamonds, which the fund intends to buy and hold with the proceeds of the initial offering.

While the financial press did not view the suggestion very favorably, it failed to notice a number of crucial issues. One observer, for example, said in a webcast that diamond funds were a bad idea because a fund “can be very easily gamed,” and that “market participants in the diamond industry...are able to influence the grading of certain diamonds and therefore able to maybe influence the types of diamonds that get into this portfolio.”

A worrisome point, perhaps, but it has more to do with the perception of the diamond industry. Public





## It is true that on an individual basis, diamonds are not homogenous. The non-standardness of individual diamonds raises the question of how they are priced.

perception of the industry may be a hurdle, although we already know it will stand or fall on its reputation.

An issue raised by many is the inconsistent character of diamonds, their fungibility – the property of a good or a commodity whose individual units are capable of mutual substitution. It is true that on an individual basis, diamonds are not homogenous. The non-standardness of individual diamonds raises the question of how they are priced.

However, in large quantities of narrowly defined categories, diamond price trends are trackable. IDEX Online, Polished Prices and Rapaport have done it for many years. Wherever there is a market, there is a price.

This is where some of the funds, those dealing in 1 carat white goods, have an interesting offering – one that Alain Vandendorre, a serial entrepreneur and founder of the Singapore Diamond Exchange (SDX), a private exchange for private investors, calls “capital preservation.”

Vandendorre identifies an opportunity and a number of problems. “There is a macro structure that includes an imbalance in the [diamond] market – the supply of diamonds is limited and demand for it is increasing,” he says. “I believe there is an opportunity, but the

market has some issues. The market is closed, so I [as a consumer] can only buy on the street and don’t know about the GIA.” SDX is the solution Vandendorre envisions, a place where investors can buy directly from the wholesale market.

Unlike IndexIQ, SDX is not a fund. Set to launch on July 25, it offers investors a wide range of goods. Investors will have the option of buying what it calls portfolios, a range of goods with a total value starting at \$250,000, going up to more than \$1 million. Investors will have a choice of portfolios to choose from, each representing a different combination of goods and expected appreciation. Such a portfolio will typically consist of 1-5 carat round diamonds, D-I color and, IF-SI2 clarities – all GIA certified. Some portfolios may also include large or fancy colored diamonds.

From Vandendorre’s perspective, the allure is clear. “Diamonds are a low volatility commodity.” Compared to some of the more common investment venues, such as real-estate or the stock market, this is correct, as shown in Graph 1. It compares three leading stock indices – the Shanghai Composite Index, the Hang Seng Index and S&P 500 – to the IDEX Online polished diamond index, of which 1 carat diamonds represent more than 12 percent. While the stock performance is widely volatile, the overall average price of diamonds is fairly stable.



“I believe there is an opportunity, but the market has some issues,” says SDX’s Alain Vandendorre.

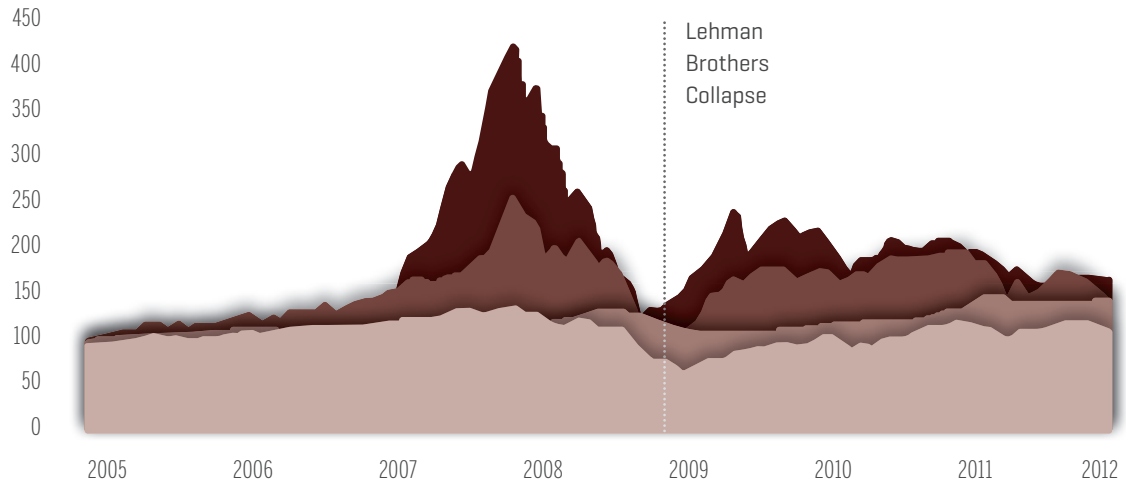
June 2004 = 100

# POLISHED DIAMOND PRICES VS. SCI, HSI, S&P 500

June 2004 — June 2012

- Shanghai Composite Index
- Hang Seng Index
- IDEX Polished Diamond Price Index
- S&P 500

Graph 1



Source: IDEX Online, Markets

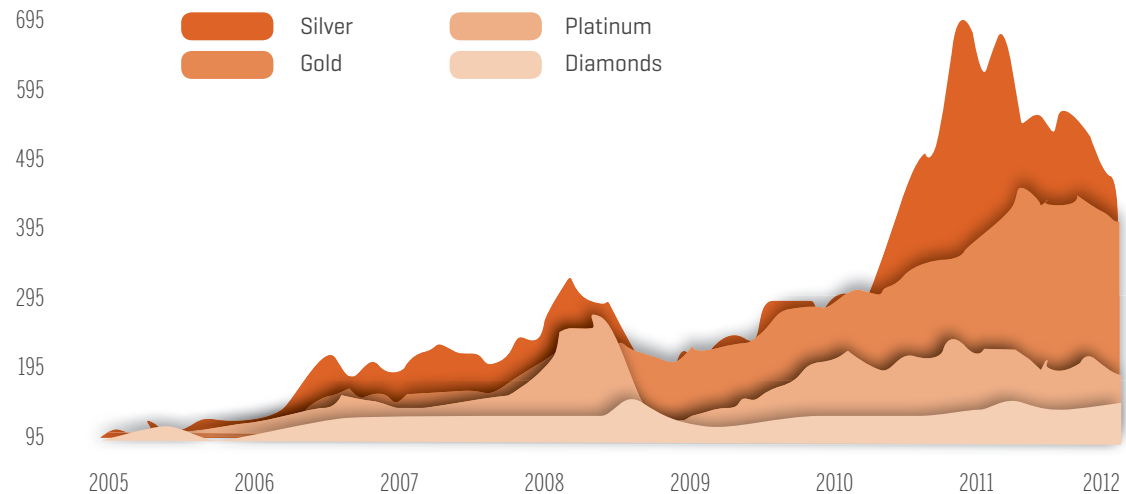
June 2004 = 100

# INDEX OF DIAMOND & PRECIOUS METAL PRICES

June 2004 — June 2012

- Silver
- Gold
- Platinum
- Diamonds

Graph 2



Source: IDEX Online, Markets



Bankers and wealth management firms today understand that such an investment should be part of their portfolios.



This brings us back to the concept of “capital preservation.” If the value of 1 carat diamonds is fairly stable – as attested by these graphs – then investors can expect a small return on their investments, but one that offers them protection when a colossal economic downturn hits – such as the one that took place in the third quarter of 2008.

Because the return on investment is not high, this venue of investment should be of interest to people trying to find a way to protect a certain amount of their money for a rainy day.

Underscoring this, Vandendorre emphasizes that SDX is not a fund, saying that SDX’s model is the “opposite of how funds work – a quick turnaround, like with gold.”

## MARKET RESPONSE TO INVESTMENTS

**O**ne important question is how the diamond industry will accept, understand and participate in such a market. Some hesitance exists, mainly among veterans who remember the Thomson McKinnon Diamond Investment Trust and who lost money in the 80’s boom and the subsequent bust. Others, however, are looking forward to the opportunities investment vehicles offer.

The most important aspect is the inflow of much-needed cash into the wholesale polished diamond sector, income from financial institutions. In a way, this is a whole new

market. Today the financial market offers the diamond industry financing, which allows companies to grow and helps them operate. This has a cost in the form of interest.

Further, with banks refusing to increase their funding of the diamond industry, the narrow-margin sector – especially diamond manufacturers – is in dire need of new sources of cash in order to develop. Investment in diamonds has the potential to generate a new flow of capital, real income that has the potential to reinvigorate the entire diamond pipeline. By buying diamonds in the market, diamond funds, and other diamond-related investment tools, could stream hundreds of millions from the financial sector.

Another concern some traders see is ballooning prices. “This will create a price bubble,” many traders have told IDEX Online. Only the future will tell how true this is. Surely, with greater demand, prices will increase.

In the long-term, the belief among supporters of investment in diamonds is that the increase will be balanced by consumers’ willingness and ability to pay for diamond jewelry. In other words, if consumers, the main source of income for the diamond industry, find the prices too high and stop buying, this may bring down prices of polished diamonds.

Some diamond traders are seeking to take part in this new arena. A number of them are actively involved in such endeavors, either as entrepreneurs partnering with financial institutions and recruited by financial institutions seeking diamond insiders, or as guaranteed sources of goods who will also buy back diamonds when investors decide to cash out.



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## POTENTIAL YET TO BE UNLOCKED

**M**any of those involved in the efforts to create investments in 1 carat white goods that we spoke with quote the potential of their specific endeavor at \$100 million or more. The Harry Winston fund, Diamond Asset Advisors (DAA), wants to raise \$250 million in its first round. The London Stock Exchange-listed Diamond Circle Capital (DCC), on the other hand, has a market cap of about \$26.9 million.

Conventional wisdom among many analysts in the diamond industry and financial markets is that the total capital that the financial sector and private investors may earmark for diamond investments is below the total expectations of hopeful entrepreneurs. Some will do well, but not all, and not everyone will find the level of investment they are seeking.

That being said, bankers and wealth management firms today understand that such an investment venue should be part of their portfolios. The wide-range estimate is that by buying diamonds in the market, diamond funds, and other diamond-related investment tools could stream hundreds of millions of dollars into the diamond industry.

## TRANSPARENCY, TRADING TOOLS

**T**he need for transparency in the diamond market is crucial. This includes coming forward on ethical issues, ensuring that the Kimberley Process operates well and that issues such as certification bribery and lab-made diamonds are not part of the equation. Absolute confidence that a certificate accurately

reflects diamonds' characteristics and that lab-made diamonds are not passed off as natural goods is essential.

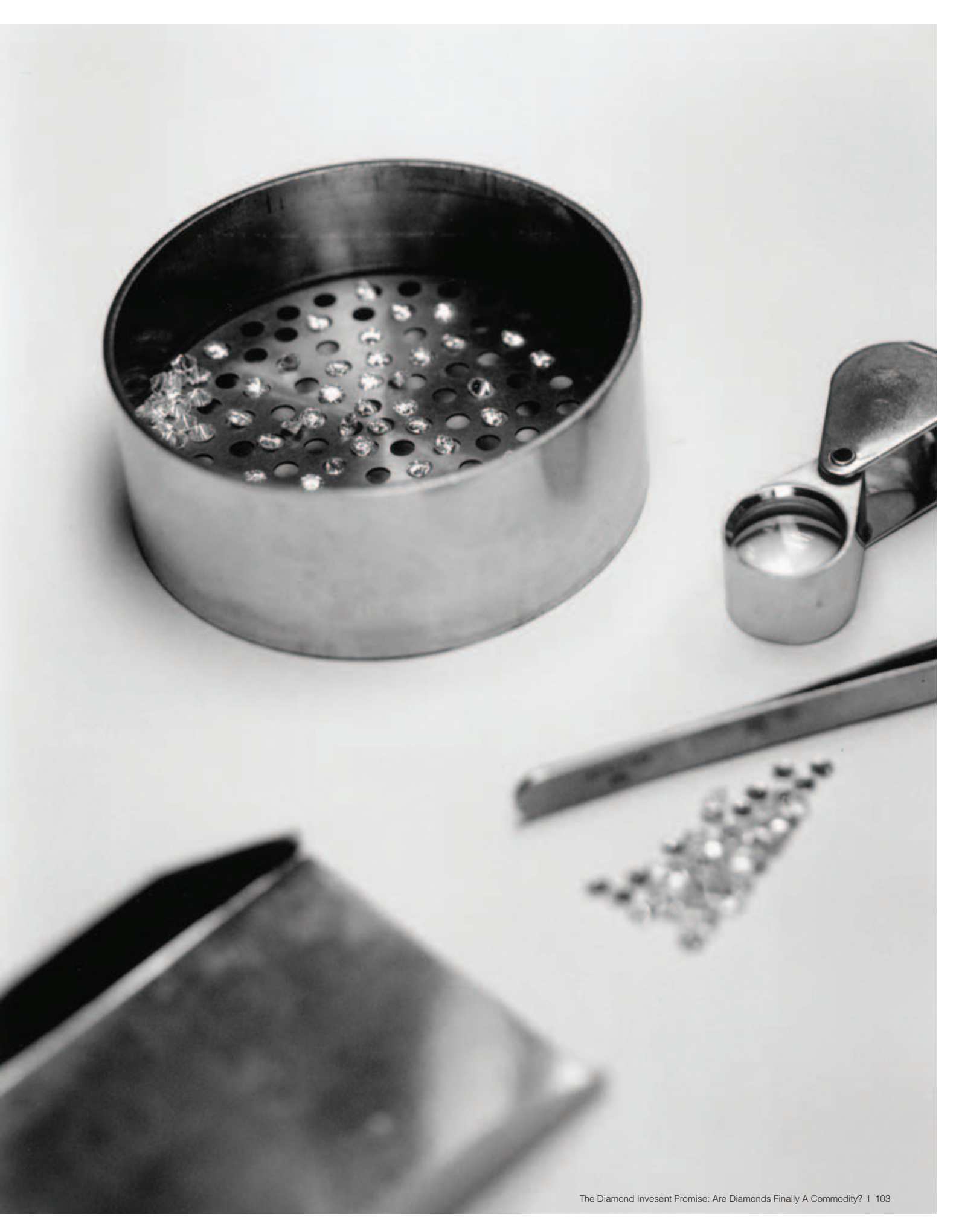
Other issues are also on the table, for example, price transparency. Many prospective firms, especially those that have diamond traders deeply involved with them, need an objective, third-party source of information to provide unbiased price disclosure.

In the past year, IDEX Online Research was approached a number of times with requests to use its polished diamond price index as a source of information on price trends. It also provided analysis on price trends of different diamond categories.

SDX will use the IDEX Online spot market , Guaranteed Diamond Transactions™ to buy and sell these goods, giving investors full price disclosure and net asset valuation.



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# HIGH-END INVESTMENTS

BE THEM PINK, BLUE, ORANGE OR JUST VERY LARGE WHITE STONES, ARE VERY RARE, VERY SPECIAL AND VERY SOUGHT AFTER, MAKING THEM A GREAT INVESTMENT.

**F**ancy color diamonds – Be them pink, blue, orange or just very large white stones, are very rare, very special and very sought after, making them a great investment.

Investment in these types of items are made mainly by connoisseurs, high net worth individuals who either understand what they are buying, or have someone trustworthy to advise them.

While the most visible are purchases made at Christie's or Sotheby's, such transactions represent only a fraction of the total business in high-end diamond trading.

"This is the best possible investment," says Eden Rachminov of Rachminov Diamond 1891, a fancy color diamond trader who authored the *Fancy Color Diamond Book*. He cites the diminishing supply of these stones as the key reason for investing.

Oded Mansori of R.D.H. Diamonds, who advises, manufactures and trades in high-end diamonds, notes that even with a steady supply, the number of rough stones mined and offered on the market is very limited. "Only two or three rough stones that result in +10 carat D/IF stones enter the market in any given month," he says, adding that there is hardly any price decline in these goods because they are usually in "strong hands." This means traders who can afford to hold on to an expensive stone for a while and not sell for a lower price.

This trait characterizes high-end diamond investments. "Even in the secondary market, goods return to the market rarely. Usually they remain in the hands of the family," says Mansori. "High-end diamonds return to the market less often than say diamonds of about 3 carats, which are sometimes sold to pay a debt or a mortgage."



**ODED MANSORI**

**MORE AND MORE MONEY FROM OUTSIDE THE DIAMOND INDUSTRY IS SEEKING HIGH-END STONES, AND ALWAYS PREFERS BUYING THE HIGHEST QUALITY AVAILABLE.**



## GUARANTEED DIAMOND TRANSACTIONS™

IDEX Online's Guaranteed Diamond Transactions (GDT™) is the world's first diamond spot market. The use of platforms such as GDT™ finally gives the marketplace the necessary transparency for financial institutions to purchase diamonds. To date, this is the only such platform for diamonds. Using it, a diamond investment company can facilitate buy and sell orders on behalf of its investors with an objective third party, creating a clear and transparent documentation for the firm and their investors.



Graff Diamonds paid \$24.26 million for the cushion-shaped deep grayish blue VS2 Wittelsbach Diamond, a record price for any diamond or jewel sold at auction.

He estimates that while about 4 percent of 3 carat diamonds return to the market from private hands, less than 1 percent of high-end diamonds find their way back, owing to the enduring financial wealth of those who buy high-end diamonds.

Mansori concludes, "More and more money from outside the diamond industry is seeking high-end stones, and always prefers buying the highest quality available."

Testimony to this view is the record-breaking price paid at a Christie's auction in December 2008. According to the auction house, Graff Diamonds paid \$24.26 million for the cushion-shaped deep grayish blue VS2 Wittelsbach Diamond, a record price for any diamond or jewel sold at auction.

The "Star of Josephine," a fancy vivid blue, weighing 7.03 carats, sold in May 2009 for \$9.49 million, or \$1.35 million per carat, making it the most expensive per carat stone ever sold in any category. The diamond was cut from a 39.19-carat blue diamond mined by Petra in South Africa, which sold for \$8.8 million at a tender – also during the recession.

Rachminov, while a staunch believer in the investment value of fancy color diamonds, adds some caution when discussing diamond investment firms. "Their buyer needs to be an alley cat and understand the market well," he cites as a pre-requisite for any firm investing in diamonds. "There are some former Sotheby's and Christie's guys trying to do this, but they



lack the experience.” Rachminov estimates that only about 2-3 percent of high-end goods are sold at the auction houses.

“The firm needs a buyer who is a diamond trader. The profit is in a good purchase,” he emphasizes.

Rachminov also points out an issue that still exists in fancy color diamonds – price transparency. Because so few stones are sold through auction houses, investors may not know the price for which the buyer actually bought the diamonds. Despite the attractiveness of investing in high-end diamonds, he feels that until now, none of the firms has done it right.

However, the auction houses do play an important role in the high-end diamond arena. Not only do they keep awareness high, they are market makers in terms of price and create a very high benchmark for single color diamonds.

According to both traders, buying at the auction houses is good for a long-term strategy – according to Rachminov, at least three years. They caution, however, that buying at an auction house “burns” the diamond for a while since everyone knows how much it was bought for and buyers will not pay much above that price.

In the open market, however, returns can be hefty. Rachminov says they can be “high” while Mansori estimates the appreciation at about 15 percent annually for high-end, well bought diamonds.

## NOVEL WAYS TO PRICE TRANSPARENCY

**O**ne issue that repeatedly comes up in the context of investment in diamonds is price disclosure. Most of the ventures dealing with “bread and butter” goods, are basing price disclosure on third-party analysis, for example, SDX’s reliance on IDEX Online’s market-driven data. This analysis is based on data generated from large volumes of the relevant goods.

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## I WOULD LIKE TO INVEST IN A HIGH-END DIAMOND, WHAT SHOULD I BUY?

If you are wondering what the pros have to recommend, Mansori says that in terms of fancy color diamonds, buyers should invest in diamonds with a single color without a secondary color because the value of the stone is less disputable.

Such an investment, he recommends, should start from \$750,000 with an investment horizon of at least a year. However, if you have the right item, you can make a profit in as little as six months. The right item is the best your money can buy (seriously). An investor should seek the best possible diamond in terms of color, clarity and make. If needed, compromise on size.

Mansori states, “These stones will sell in even in the depth of a harsh economic crisis, if not within hours, then within a few days.”

If you are interested in a white diamond, look for a DEF color, VVS clarity or better diamond with an excellent make weighing at least 5 carats. Mansori recommends going as high as possible – a D/IF diamond, preferably larger than 10 carats.

He concludes, “The most important factor in buying diamonds for investments is to buy from a professional you trust who will be there for you at the time of purchase and in the future.”

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With large and fancy color diamonds, this is not possible. The rarity of these items is so great that differences between goods are significant. In addition, because there are so few items sold each year – with most sales being discreet transactions – a statistical analysis is nearly impossible.

Harry Winston's DAA fund, for example, will buy these goods, which will then be handed to the jeweler on memo terms to set in its jewelry. It will then offer the jewelry at its boutiques around the world. Once sold, Harry Winston is paid a fee for the selling service, and the fund receives the rest of the proceeds. This is an elegant solution to the price discovery issue. Investors will know how much a diamond has sold for, not just the price of diamonds like it.

DAA is currently in the process of raising the first \$50 million of a total of \$250 million. About a quarter of the capital will be put in "Special Allocation" of special stones: 6 carat and larger DEF color, or fancy color diamonds of any size. The expected turnover of these goods is 0.8 times a year, carrying an expected return of 15-30 percent.

The remaining 75 percent of the capital will be invested in the core allocation of 0.5-5.99 carat DEF goods. Here the expectation is that turnover will be about once a year, with an expected 13 percent appreciation.

All goods will be VS+ clarity, non-florescent with at least Very Good make and will need to pass Harry Winston's quality control system to ensure they are suitable as Harry Winston jewelry items.

One criticism the fund is facing is that, in a way, investors are being asked to finance Harry Winston's inventory. With a name for expensive, high-end stones, the kind that typically take one to three years to sell, this is clearly an expensive inventory. Coupled with the company's drive to add more boutiques, the need to enlarge this inventory faster than it sells it is clearly a major burden on the retailer's financing.



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Asked about the two "allocations," an insider said the goal in defining the range broadly is to avoid a price bubble. If the company buys \$50-\$75 million worth of narrowly defined rare diamonds at once, the market will react with price increases, decreasing the margin of appreciation.

The DAA system will have an extra benefit. It will create a large database of prices of special goods. After a while, and once it reaches critical mass, this database could serve as a price benchmark for this range of goods.



# INVESTING IN DIAMONDS

by Eden Rachminov

## FROM CLOSE-ENDED FUNDS TO EXCHANGE TRADE FUNDS [ETFs], INVESTMENT IN DIAMONDS HAS BECOME THE ASSET-CLASS TREND OF 2012.

**O**n the one hand, high net worth individuals and institutional investors have been witnessing continuous erosion in their traditionally high returns from real estate, private equity, global equities and bonds. On the other hand, tangible assets and minerals, such as gold and diamonds, have been consistently outperforming traditional asset classes.

As more baby-boomers grow restless over meager nest-egg returns caused by a sluggish economy, a depressed real estate market and a zero percent interest environment, they have discovered alternative asset classes as a potential means to diversify small portions of their investment portfolios.

Some savvy investment professionals believe that diamonds, especially unique and rare fancy color

ones are the next asset class to penetrate global portfolios. Consequently, I believe the diamond investment trend will not fade away anytime soon.

Nevertheless, investors who seek high returns should consider the following: first, “diamonds” do not constitute a homogeneous asset class; some categories of diamonds may produce extraordinary returns, whereas others may disappoint. Second, the traditional and not-so-sophisticated buy-hold-sell investment model usually fails to achieve high returns. This fiercely competitive practice has eroded profitability for the most part, and margins are simply not there.

Addressing the first assumption, most diamond categories are (almost) commoditized. In the



Recently, fancy color diamonds, especially the larger and rarer ones (typically with an individual price tag of \$500,000 and above) have emerged as a unique and attractive investment opportunity.

coming years, with further developments in technology, and a continued tendency towards full supply-chain transparency, most diamonds will offer modest returns as investments. The most vivid exception to the margin rule is fancy color diamonds. The reason for this difference is due to their rarity and unique characteristics.

Only a miniscule fragment of diamonds possess natural color – and are referred to as a fancy color diamonds. They are purchased almost exclusively for the intensity and distribution of the diamond's color, as opposed to colorless diamonds where the 4Cs are primary indications of value. For fancy color goods, as a rule, the more intense the color, the rarer and more valuable the diamond.





On the demand side, as rare fancy color diamonds typically sell at retail prices surpassing \$1 million their consumer profile is meaningfully different from that of a typical diamond buyer.



Prices of these goods have shown strong price appreciation in the past few years, and experts claim this trend will continue in the foreseeable future.

They add that these rare diamonds have proven to be resilient to adverse economic conditions with only marginal price declines occurring during recent general economic downturns. Declining global supply of rare fancy color diamonds is one of the reasons for durable prices as mines have yielded fewer and fewer of those rare stones each year, and no new significant diamond mines with notable fancy color diamond production have been discovered.

Another important driver for price appreciation is the increasing demand for rare fancy color diamonds due to the general worldwide demand for tangible asset investments and the growing number of high net-worth individuals, specifically in Asia.

Moreover, some investors believe that, based on past pricing performance, rare colored diamonds may provide excellent inflationary hedges.

Finding rough diamonds is random and impossible to predict. Therefore, due to the difficulties in mining, the projected rough fancy color diamond supply is expected to remain unchanged or to decrease slightly for years to come. It is unlikely that the primary supply picture for rare fancy color diamonds will improve before the end of the decade.

On the demand side, as rare fancy color diamonds typically sell at retail prices surpassing \$1 million their consumer profile is meaningfully different from that of a typical diamond buyer.

In 2011, the typical end-consumer who purchased a rare fancy color diamond was a male, shopping independently or accompanied by his partner. This consumer is referred to as an Ultra-High-Net-Worth-Individual (UHNWI) and is often a jewelry and diamond connoisseur who has purchased important white and/or color diamonds in the past and understands the unique proposition of the fancy color diamonds. Increasingly, this consumer is purchasing the item for investment (or price appreciation potential) purposes, in addition to other reasons.



Any investment vehicle would have to develop a proprietary route to market for its diamonds, to secure a consistent, high-margin sourcing and distribution platform. Usually, this is achieved through long-term partnerships that link stakeholders from different parts of the global supply chain. The obvious need for cooperation will provide significant added value to the industry, in tearing down trade barriers and promoting transparency and further trust.

One final observation: As with any other hyped asset class, investors may come across numerous individuals and investment vehicles that promise high returns and

meaningful upside potential when investing in diamonds. Some of these outfits are highly professional and credible; others may not be. A wise investor should insist on looking at an audited and proven performance track record and conduct a proper due diligence process before investing, just as they would do with any mutual fund or ETF.



Eden Rachminov is principal of Rachminov Diamonds 1891 and author of *The Fancy Color Diamond Book*, considered to be the diamond industry's primary tool and reference guide for fancy color diamonds.

# PRICE TRENDS AND THE FORCES THAT SHAPE THEM

THE IDEX ONLINE POLISHED DIAMOND INDEX WAS INTRODUCED ON JULY 1, 2004. THE INDEX IS DERIVED IN REAL-TIME FROM ACTUAL ASKING PRICES OF THE GLOBAL DIAMOND INDUSTRY, OBJECTIVELY REFLECTING PRICE TRENDS AS THEY HAPPEN.

**C**omprised of 15 drivers that represent the leading diamond categories and accounting for approximately 45 percent of the polished diamond trade, the IDEX Online Polished Diamond Index is updated on a daily basis. This database includes inventories of major industry players, accounting for approximately 75 percent of the global trade.

## **STRONG DEMAND BY NEW RETAILERS IN CHINA AND INDIA CREATES PRICE BUBBLE**

Since its launch, the index has risen by approximately 40 percent on a first day to last day basis.

During its first four years, from mid-2004 to early 2008, diamond prices increased moderately, as the global consumer economy improved and rough diamond prices continued to rise.

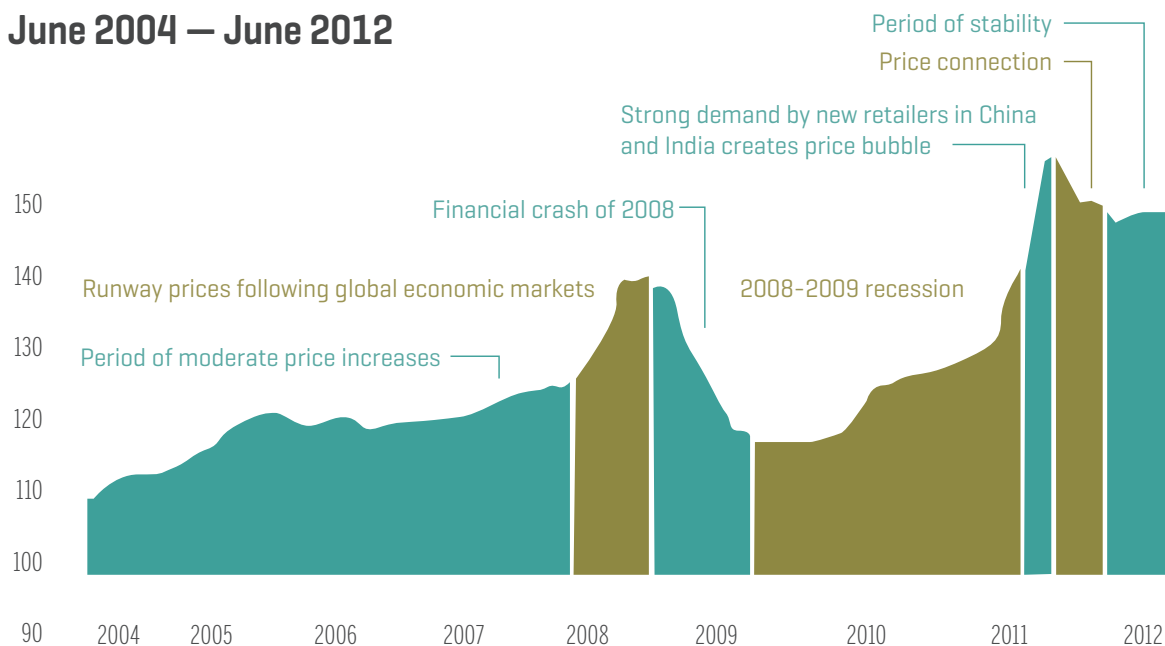
In 2008, prices started to escalate in a delayed response to the strengthening markets. Prices reached a record high in June of that year – just ahead of the key U.S. trade fair, JCK Las Vegas – and peaked in August at 128.91.

Following the global financial crash, diamond prices plunged to mid-2005 levels, reaching a low of 108.56 in September 2009.

The 2009 Holiday season was far better than the industry expected, and prices of polished diamonds have been on the rise ever since. At the same time, in response to the recession, diamond

# IDEX ONLINE POLISHED PRICE INDEX

June 2004 — June 2012



Source: IDEX Online Research

manufacturers have streamlined their operations, sold off old stocks, taken advantage of the low rough prices and started purchasing rough with growing impetus.

This led to quickly rising rough diamond prices that started to pressure manufacturers to increase the price of polished. This momentum continues until today, backed by a large and growing demand from the Chinese and Indian consumer markets and a recovering U.S. market.

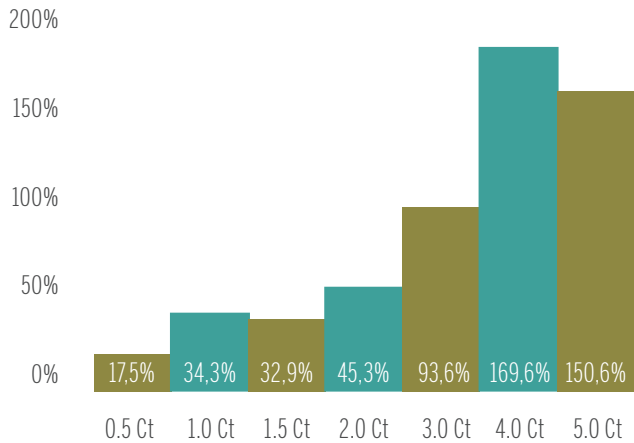
In June 2011, polished diamond prices broke records, after bottoming in September 2009. Within a year, polished diamond prices rose by 15.8 percent, according to the IDEX Online Polished Diamond Index. This was the largest such price increase since pre-crisis June 2008, when prices shot up by 14.5 percent year-over-year.



This momentum continues until today, backed by a large and growing demand from the Chinese and Indian consumer markets and a recovering U.S. market.

# POLISHED DIAMOND PRICES

## Round by Size June 2004 vs. June 2012



Source: IDEX Online Research

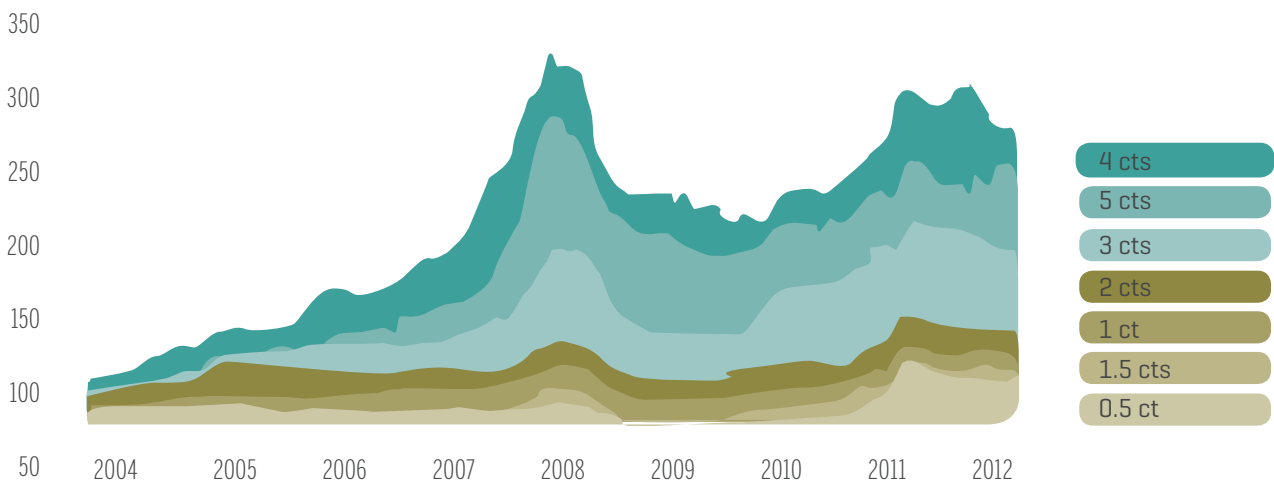
Furthermore, prices have risen almost every month since the last quarter of 2009 through August 2011.

In the first half of 2011, unprecedented demand from China and India, mostly from new jewelry store openings (China) and a shift from gold jewelry to diamond jewelry (India), resulted in a sizzling market and a price bubble.

In today's post-cooling period, after having plateaued, prices of polished diamonds are declining. This is a response to uncertainty in some global markets and vigilance in the more stable countries such as China. This is also a much needed price correction. Our outlook is that as the year-end nears, prices will recover and in the long-term continue their overall increase.

# IDEX ONLINE ROUND POLISHED DIAMOND PRICE INDEX

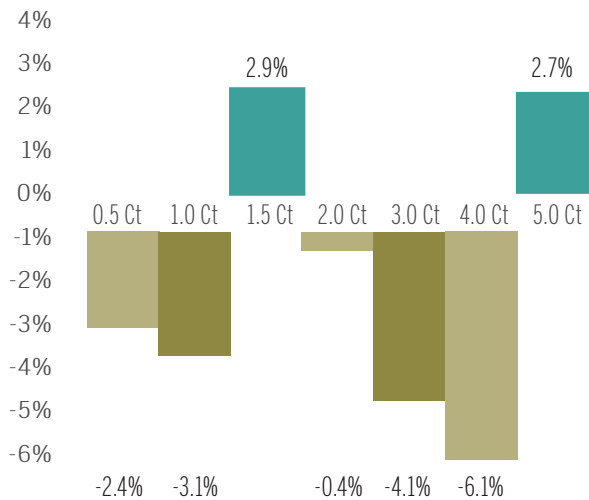
## Index by size July 2004 — June 2012



Source: IDEX Online Research

# ROUND POLISHED DIAMOND PRICES

by Size June 2011 vs. June 2012



In today's post-cooling period, prices of polished diamonds are stable. However, the price inflation of polished diamonds hit a high in June 2011, making year-over-year comparisons look dismal at best.





# THE INFAMOUS FORERUNNER: THE THOMSON MCKINNON DIAMOND INVESTMENT TRUST

IN MARCH 1981, AFTER A LONG RUN OF INFLATIONARY DIAMOND PRICES, THOMSON MCKINNON ASSET MANAGEMENT INC. LAUNCHED THE DIAMOND INVESTMENT TRUST, ONE OF SEVERAL TRUSTS IT FORMED TO INVEST IN DIAMONDS.

**T**he timing was unfortunate. In retrospect, diamond prices were past their peak and cooling, leading to the collapse of the trusts.

At launch, shares in the Trust traded at \$994. As investors got wind of the quickly declining diamond prices, the fund's shares lost favor, dropping to \$565 seven months later.

A year earlier, in 1980, D / FL 1 carat diamonds were selling for \$50,000. By 1985, prices among wholesalers had dropped to \$8,000-\$12,000 in what is considered till this day to be one of the worse crashes in diamond price history.

According to *Barron's Finance & Investment Dictionary*, the Diamond Investment Trusts invested in high quality diamonds. Barron's warned, "Shares in these trusts do not trade actively and are therefore difficult to sell if diamond prices fall," as they did soon after the first trust was established.

Loose polished diamond traders still view the steep drop in diamond prices in the 1980s with near horror. Some of them lost a considerable amount of money when the value of their expensively bought inventory lost a large portion of its value. In some cases – as in the 1 carat example – the value of inventories was slashed by as much as 80 percent.

This resulted in a large number of bankruptcies and the fall of a number of very large companies, which dragged the industry into a major economic catastrophe.

Although launched after prices started to decline (but before the quick tumble), the Thomson McKinnon Diamond Investment Trust is still associated with the price decline in the minds of many in the wholesale sector. This lingering memory is why many of them oppose the formation of diamond funds today.

Is the Thomson McKinnon Diamond Investment Trust the ultimate warning against investing in diamonds? Not necessarily.

First, the timing of the trust was unfortunate. While diamond prices are currently softening, the declines are nowhere near the free fall of the mid-80s. In addition, the Trust was a futures market. None of the proposed investment opportunities today is a futures-oriented one, ostensibly creating lesser impact on long-term pricing.

Finally, Thomson McKinnon Inc. was likely suffering from a number of problems unrelated to diamonds. Although it tried to ride the tidal wave of escalating diamond prices, it did not recognize the change in market direction and failed to hold off issuing the shares.



Although launched after prices started to decline (but before the quick tumble), the Thomson McKinnon Diamond Investment Trust is still associated with the price decline in the minds of many in the wholesale sector.

## INVESTING IN DIAMONDS – THE LOWDOWN

	1 Carat Whites	High-End Diamonds
Type of investment	Wealth preservation	Investment appreciation
Typical annual target returns*	~4%	~10%-30%
Size of investment	Several thousand \$ and up	Minimum \$750,000
Advantages	Fits any investor type, price fairly stable compared to other investment venues, good wealth protection in economic downturn, portable if investor has physical hold	High returns, unique investment, highly portable store of wealth
Disadvantages	No passive income, physical hold not always available.	Only available to HNWI, difficult to buy first hand, requires high level of trust in seller, no passive income, price information difficult to come by due to the uniqueness and rarity of each stone.

\*IDEX Online estimates based on average 10-year returns.