Private Wealth

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Off To The Races

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Want a good tip? Don't bet on the horses.

With Triple Crown season here, perhaps the punch line to the classic joke should be updated to, don't *invest* in the horses—or rather, don't let clients invest unless they clearly understand that racing and breeding thoroughbreds is a highly speculative endeavor. Experts note that 90% of participants lose most or all of their capital.

"There are easier ways to make money and there are certainly less risky ways to make money," says Barry Irwin, founder and CEO of Team Valor International, a Lawrenceburg, Ky.-based thoroughbred syndicate, as racing partnerships are called in the industry. Irwin says the ultra-wealthy get involved with thoroughbreds for other reasons. "It's the excitement factor. There's a lot of glamour involved. And there's risk-taking. You're going to find out whether you have a hit or a failure pretty quickly."

Irwin knows all about the thrill and allure of thoroughbreds. Team Valor's most famous horse, Animal Kingdom, won this year's Dubai World Cup. The richest race in the world was held at the end of March. As a reward for coming in first, Animal Kingdom got more than a bucket of oats. His share of the $10 million purse was $6 million.

Animal Kingdom, who was bred by Irwin from a filly he bought in Germany, also won the 2011 Kentucky Derby. A 20-to-1 long shot, he took home $1.2 million of that race's $2 million purse. As of this writing, he's earned almost $8.4 million. When he retires to stud, he'll no doubt be worth tens of millions more.

Irwin says only those with a love of the sport and plenty of disposable income should consider getting involved. "Our partnerships are geared for entertainment and fun. We try to make money. But if anybody uses the term 'investment,' I immediately stop them. I say, 'This is not an investment. This is a 100% indulgence.'"

This is precisely the time of year when advisors may need to rein in horse-loving clients excited by a trip to the Kentucky Derby who decide on a whim to enter this risky business. Irwin, who personally evaluates all the horses that Team Valor acquires, rarely advertises horses for sale; but he says some of his competitors make money from impulse purchasers. He's seen people behave rashly in response to viewing post-derby TV ads. "Next thing you know, they've bought a racehorse. I wouldn't buy a dog like that," says Irwin.

The Starting Gate

There are essentially two ways to make money on thoroughbreds: breeding and racing.

Either way, it all begins with a horse or horses. While Kentucky is by far the biggest producer of thoroughbred foals in the U.S., significant breeding activity also occurs in Florida, California, Louisiana, Pennsylvania and New York.

Before retiring five years ago, Dan Rosenberg of Midway, Ky.-based Rosenberg Thoroughbred Consulting was involved with six Kentucky Derby winners and Triple Crown winner Seattle Slew in his 30 years as manager of the legendary breeding operation at Three Chimneys Farm in Midway. Rosenberg says he's been asked many times if his experience taught him the secrets to picking Triple Crown winners. "I've been around a lot of really, really good horses. I knew some of them had an enormous chance to be successful, but I didn't know for sure. If I'd known, I'd have bought them. I'd be a billionaire."

Choosing a potential champion is so difficult that Irwin says he looks at about 70 horses per month and may buy one.

Rosenberg says it's essential that newcomers to the industry understand their goals and budget and seek out experts who are a good match for their personalities. "People who are very successful in other businesses come into this business and abandon all the principles that made them successful in the first place. You need a business plan," he says.

Rosenberg helps clients find professionals like bloodstock agents, who advise the buyer or seller of a thoroughbred at a public auction or private sale; trainers to prepare the horse if it's going to race; accountants who understand the complex tax issues surrounding thoroughbred ownership, including the rules on capital gains and losses, as well as passive and hobby losses (see sidebar); attorneys who can draw up legal agreements specific to buying, selling and breeding a horse, as well as starting or investing in a racing partnership; and veterinarians who can keep a horse healthy and deal with injuries.

"Because this business is so speculative, there are great opportunities for people to take advantage of you. It's very important to do your homework, get references, interview people and make sure that you've got reputable people representing you," Rosenberg says.

Horse Trading

Taking a pedigreed mare, matching her with a thoroughbred stallion and selling the foals can be less risky than racing. It can also deliver steadier returns.

Racing can be more lucrative, but the downside is worse. The horse could be scratched before post time, say because it doesn't pass a pre-race veterinary exam. It could have a temper tantrum and throw its jockey. It could get sick, injured or even die.

Logically, the best time to buy is when a horse is cheap, usually because it is young and unraced or barely established on the track.Then the best time to sell is just after the horse wins a big race and it's at peak value. But Irwin says owners bond with their horses and are often reluctant to part with them.

The amount owners can earn racing varies significantly depending on the race. Higher-paying events, known as stakes races, could have $50,000 to $1 million or more in the purse. First place usually gets 50% to 60%, second gets 20% and third gets 10%. Some races pay all the way down to fifth place. Of the winner's cut, the trainer and the jockey get 10% each and the owner gets the rest.

Even if a horse wins millions at high-profile races, stud or broodmare services often eclipse purse monies. In general, male horses are worth more than females. A stallion can father 100 to 150 foals per year; a mare can deliver only one. A stakes-winning stallion could ultimately rake in $10 million to $50 million in stud fees after he retires from the track, and command $20,000 to $50,000 per breeding session. While the price tag for a breeding session might seem high, the owners of the mares get the foals for far less than they'd pay buying a young horse at an auction or a private sale.

Breeding sessions must involve a stallion physically breeding with a broodmare, because the Jockey Club does not approve of artificial insemination. This club, which maintains offices in New York City and Lexington, Ky., serves as the breed registry for all thoroughbreds foaled in the U.S., Canada and Puerto Rico, as well as all thoroughbreds imported into these areas from other nations that keep similar registries. "We make sure that each foal is the son or daughter of registered thoroughbreds through DNA testing. We also approve names for horses," says Bob Curran Jr., vice president of corporate communications at the Jockey Club.

A foal's name frequently combines elements from those of its parents. Animal Kingdom's sire was Leroidesanimaux ("Le roi des animaux" is French for "King of the animals.") Funny Cide, winner of the 2003 Kentucky Derby, got his name from his sire, Distorted Humor, and his dam, Belle's Good Cide.

Names are checked against about 430,000 existing names. Potential names can't exceed 18 characters or have a commercial association. Notwithstanding the occasional Ménage Á Trois (1974) or Bodacious Tatas (1985) slipping past the screeners, naughty names are also a no-no.

Holding Your Horses

There are basically three ways to invest in thoroughbreds: outright horse ownership, joining a syndicate or buying into a fund.

The days of wealthy individuals and families raising Kentucky Derby winners have faded, in part because of the costs and complexities of topflight horse ownership. The price of a thoroughbred can vary greatly, depending on its age, pedigree and racing history. Horses that have already raced and performed well cost significantly more. Yearlings cost less, but they're unproven.

It's possible to buy a decent thoroughbred for as little as $30,000. But to spread the risk over several good quality horses and increase the odds of winning, experts say it takes more like $500,000 to several million dollars just to get started. The purchase prices of Kentucky Derby winners have varied considerably. Animal Kingdom was purchased for $100,000 in 2009. Fusaichi Pegasus, who won in 2000, was bought in 1998 for $4 million. No matter the initial cost, ongoing expenses for feeding, training and maintaining a thoroughbred can exceed $50,000 annually.

Potential owners can get an idea of what's involved from OwnerView.com, an online tool that provides information about the process and economics of horse ownership. The site was recently launched by the Jockey Club and the Thoroughbred Owners and Breeders Association (Toba). Toba is a trade association based in Lexington that runs educational clinics and seminars around the country for prospective and established owners and breeders.

Another way to participate is to become a member of a syndicate. "When you join a syndicate, you're sharing the risk," says Irwin.

The cost varies with the number and quality of horses in the syndicate and how many investors are involved. Some syndicates are formed around a single horse. Five high-school friends bought Funny Cide in 2002 for $75,000. He won the 2003 Kentucky Derby and Preakness Stakes, but finished third in the Belmont Stakes, coming up short of the Triple Crown. Still, he earned millions for his owners during his racing career. He's such a celebrity, he even has his own book, *Funny Cide: How a Horse, a Trainer, a Jockey, and a Bunch of High School Buddies Took on the Sheiks and Bluebloods . . . and Won*. His owners were lucky he had a lucrative racing career—lifetime earnings of over $3.2 million, according to his Web site—because, as a gelding, Funny Cide never earned stud fees.

Friends getting together to form a syndicate is more the exception than the norm these days. Most syndicates are run by professional management firms, such as Team Valor. Other well-respected syndicates include Three Chimneys Racing, West Point Thoroughbreds, Centennial Farms, Starlight Racing and Dogwood Stable, whose president, W. Cothran "Cot" Campbell, originated the idea of partnerships in 1969.

A quick way to compare some basic statistics on the various North American syndicates is to use the "syndicates" tab on OwnerView.com.

The business models of syndicates can vary significantly. Some establish limited liability companies and sell shares in all the syndicate's horses, as opposed to selling shares in individual horses, which is the model Team Valor uses. "Some of them deal with just very, very high-end horses. Others specialize in finding real bargains, $30,000 to $40,000 horses. If the horse does well, everybody benefits," says Gary Falter, vice president of operations at the Jockey Club.

Syndicates often vary the ages of their horses in order to compete in races for 2-, 3- and 4-year-olds. This helps minimize the risk and maximize the chance of developing a big-time winner. It also keeps the pipeline full of fresh prospects in training for future races.

Minimum investments can run from as little as a few thousand dollars to hundreds of thousands. The term of the investment is usually three to five years. After the initial investment, owners are typically billed quarterly for their percentage of the yearly expenses associated with each horse, such as feed, stable fees, training and jockey fees, race entry fees, farriers, insurance and transportation to events.

Experts say it's wise to avoid syndicates that require investors to purchase a piece of every upcoming offering as well as those with no cap on the animals' maintenance costs. If one or more of the horses gets seriously ill, investors could be on the hook for expensive vet bills. Another thing to note: Syndicates usually maintain liability insurance, but they don't provide mortality insurance. It's more common for investors to obtain their own coverage. According to Rosenberg, coverage isn't generally available for losses resulting from poor health, injury, veterinary bills or infertility. It can be purchased for stallions, but only for the first year they go to stud.

Advisors should caution clients not to go into a syndicate—even one with an excellent track record—thinking it's a surefire way to make money. Even with professional management, the chances of profiting are still low. It does, however, give those new to the industry a chance to own a piece of a good horse or horses, meet interesting people and have some fun. Joining a syndicate can also give newcomers a chance to learn the business.

Besides owning a horse or joining a syndicate, clients can buy a hedge fund that invests in thoroughbreds, such as the International Equine Acquisitions Holdings or Thoroughbred Legends Racing funds. Most horse hedge funds use the typical 2% / 20% fee structure and have minimums north of $500,000. They can be riskier than syndicates, as they tend to make concentrated bets on a few horses, which could mean big bucks or negative returns.

Investors should also note the thoroughbred industry is not without its ethical challenges. "Chicanery. Underhanded dealing. Backdoor commissions. Duplicitous stuff. It's unbelievable," says Irwin, who testified before Congress in 2010 about the industry's problems and who is working to ban the use of diuretics, drugs that make horses urinate so they're lighter when they race. He also takes issue with the practice of "dual agency," where bloodstock agents take commissions from both buyer and seller.

And despite the efforts of the Jockey Club, Toba and numerous adoption agencies to place retired thoroughbreds in new homes, an estimated 10,000 animals are sent annually from the U.S. to slaughterhouses in Canada and Mexico.

Irwin's warnings about the industry's problems should serve as a reminder to investors to check references, so they can shun the bad actors and savor what is often called the "Sport of Kings."

Thoroughbreds may be one of those rare investments that allow clients to feel like winners, even when they lose a king's ransom, those in the sport say.

"Anybody who has ever experienced thoroughbred racing will tell you this: The thrill, the pounding in your heart, when your horse is in the starting gate, is an extraordinary experience. And winning is even better," Rosenberg says.