A stronger appetite for low-volatility investments is driving investor demand for colored diamonds. This asset class, traditionally ruled in secrecy by a few diamond dealers and high-end jewelry retailers, is being nudged into price transparency. This year a few hedge funds have entered the space, cutting out middlemen while raising millions in an attempt to grab double-digit returns on rare gems that keep rising in price.

The mines that historically have produced rare diamonds that are at least 1 carat in size and that are most valued for gradations of their yellow, pink or blue tones (e.g., purple pink) have reached capacity, and owners won’t commit more capital to mine for new colored diamonds. In the meantime, demand has increased from emerging market investors who see colored diamonds as a safe and portable investment. The result has been a spike in prices for which even industry experts won’t predict a ceiling.

Advice for novice investors
Investors looking for an inflation hedge or tangible assets with less frenetic price swings than other investments are becoming diamond dealers’ newest customers. Alan Bronstein, an industry veteran, former colored diamond dealer
and creative force behind the diamond specialist firm Aurora Gems, spends much of his time teaching newcomers how to buy investment diamonds.

He advises buying a stone of at least 1 carat and being prepared to spend anywhere between $500,000 and $5 million for a colored diamond that will sell for a profit down the road.

"The trick is to buy a stone desirable by the diamond trade — not just the retail market," Bronstein says. "There are not that many people out there eager to buy million dollar gems. It's the trade that consumes itself most often."

In some countries, colored diamonds are also being viewed as a currency alternative. Bronstein points out that he's seen more buying of these rare gems in the last few months by high net worth individuals living in the Middle East, where political unrest persists following the Arab Spring uprisings. "If you have to leave a country fast or fear a bank collapse, it's easy to carry this investment with you," he says.

Consultants such as Bronstein and professional money managers agree that working with a network of international dealers knowledgeable about the estate sale market in which colored diamonds are often found may bring better results than working with traditional auction houses.

In addition, dealer inventories are often deep. "When demand seems to rise and people are paying higher prices, colored stones suddenly come out of the woodwork," explains Bronstein. "Dealers who've been hoarding them in their safes finally decided to show them."

New investment paths open

For those interested in colored diamonds, there are new investment paths available. At the end of 2010, two seasoned jewelry veterans teamed up with $6 billion alternative investment hedge fund Sciens to start the Sciens Coloured Diamond Fund.

Mahyar Makhzani and Philip Baldwin, the fund managers, launched their fund with $25 million, and told Alchemy that assets under management have grown to $75 million as of the 2011 third quarter. "We hope to close the fund in the near future at $150 million and have sold five diamonds in our fund for a profit," Makhzani adds.

Makhzani says that the timing of a sale is as important as that of the purchase. As a result, he's set up a closed-end fund and locked investors in for three years. He also doesn't take fund performance fees until the fund unwinds and his investors earn, he hopes, a double-digit return.

The Sciens fund also sells diamonds to its investors. For example, in July the fund sold a diamond it had bought eight months earlier for $950,000 to a fund investor for a price approximately 10 percent higher. That investor has
placed the diamond with Sotheby’s, which will put it up for auction at a $1.55 million net reserve.

Dealer funds enter the arena
Since the Sciens fund’s successful launch, diamond dealers have started their own funds. Novel Collection, a specialty diamond dealer, teamed up with a former China equities trader, Alan Landau, to start Novel Asset Management in July.

The Novel Diamond Fund 1, which Landau believes can make his investors a 20 percent return net of fees, also is closed ended and locks investors in for two years. The fund had attracted $10 million as of mid-August, with a goal to close the fund in October with $20 million.

Novel’s business model, which has raised the eyebrows of some diamond dealers, is to buy colored diamonds at wholesale prices and make money on the spread by selling them to the retail trade. Novel, which hopes to set up multiple funds with $25 million to $50 million in assets every six months, doesn’t have its own sales team. Instead Novel Asset Management will pay a commission back to Novell Collection, which Landau says has 14 sales representatives who have strong relationships with wealthy Asian buyers.

Bronstein says wholesale and retail are just concepts in the colored diamond world, and it’s possible to get a 20 percent return on the right gem if demand stays strong and the investor seeks the advice of a colored diamond expert to select the investment gems.

Whether investors choose to buy individual colored diamonds or buy into a diamond investment fund, it’s clear that this asset class is gaining fans.