CHAPTER 6:

Commercial Investment in Microfinance: A Class by Itself?

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Commercial investors are guided by asset allocation strategies. These strategies basically define the universe of possible investments and the proportion of each asset class they will buy for a given portfolio.[2] This means that even before the quality of a specific investment can be considered, the relative interest of an investor is more or less set.

For the most common types of investors, asset allocation strategies are so well defined that they result in fairly predictable investment patterns. Generally speaking, asset allocation principles of the most common types of investors transcend international boundaries. This means that the relative proportion of a given asset class in a Peruvian or South African pension fund will be roughly the same as those found in a US or British fund, with obvious differences influenced by local economic conditions and regulatory regimes.[3] Thus, the processes investors use to allocate funding to asset classes are of great interest to microfinance; they define the type of investor and the proportion of assets that an investor is likely to con-

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[1] This chapter is based on Part 2 of "Financing Microfinance Institution: The Context for Transitions to Private Capital," by Marc de Sousa-Shields, Cheryl Frankiewicz and others, commissioned as microreport #8 by the Accelerated Microenterprise Advancement Project (AMAP) of USAID, December 2004. The contractor was Chemonics International, Washington DC. (www.microLINKS.org) The author is Research Director for the Transitions to Private Capital topic of AMAP.

[2] Asset allocation, the process of dividing a portfolio into major asset categories, such as bonds, stocks or cash, is used to manage risk and maximise profit through portfolio diversification.

[3] Asset allocation strategies, as used here, are defined at the broadest level. In practice, asset managers have distinct views on the economy and adjust their holdings strategically. This usually involves differential weighting of higher and lower risk investments within portfolios. The most common difference is variations of the proportions of equity versus income investments.

sider investing in MFIs. (MFI investment is used in this chapter to refer to direct investments in MFIs *and* indirect investment through private microfinance investment funds – MFIFs – that invest in MFIs.)

Unfortunately, the asset class or classes to which microfinance investments belong is not yet established, making it difficult to explain them to commercial investors. It also makes benchmarking, or comparing the performance of a given asset against a group of its peers, difficult if not impossible. This diminishes the attractiveness of microfinance investments because most commercial investors must prove to regulators and clients that they are making sound investment decisions.

Establishing MFI investments as an asset class is therefore important if commercial capital is to be forthcoming on any scale. It is also a necessary step towards identifying where MFI investments fit within investor asset allocation strategies, and towards defining the "universe" of potential investors.

MFIs as an Asset Class

The risk and return potential of a given investment is normally understood by comparing it to an established asset class benchmark. Benchmarks are useful tools that define the relative standards by which competing investments are judged. Most equity mutual funds in the United States, for example, use the Standard & Poor's (S&P) 500 as a benchmark. When assessing an investment, it is important to compare it against the appropriate benchmark. For example, comparing a bond fund to a small capital company stock index is not particularly meaningful because they have distinctly different risk levels. Categorising an asset class is therefore critical for understanding an investment's expected risk and return potential.

Because they are not a well-defined asset class, investments in MFIs do not fit into the framework governing commercial investor asset allocations. As a result, commercial investors considering an MFI investment have to judge MFIs on the basis of perceived risk rather than established asset class expectations. Perceptions vary greatly and are not particularly helpful in understanding the potential for commercial investment in microfinance.

When no particular benchmark is available, a fund manager would customarily compare the perceived risk associated with each MFI investment instrument to the *closest approximate* perceived asset class. This is technically confusing because asset classes are normally compared to benchmarks, not to one another (e. g., saying MFI debt is comparable to the risk of a small capital equity). Hence, comparisons are not intended to be technically correct, but rather to provide a general sense of how private investors may perceive asset class risk on their risk spectrum. This approach provides an idea of the potential of an MFI investment opportunity relative to the risk spectrum understood by conventional investors.