

Investing in microfinance institutions not as risky

By Kathryn Tully, FT.com site
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Muhammad Yunus, who won a Nobel peace prize for his role in starting Bangladesh's Grameen Bank, one of the world's first microlenders, once said that poverty was "something like a bonsai tree. You get only this little base to grow from. You are a stunted little thing. Maybe you could be a giant thing, but you never find out – that's poverty."

Much the same applies to microcredit itself, in the eyes of big investors. How can you tell whether a man selling fruit at a market in Nairobi represents a sound investment? Until you can do this, the capital available to the sector, which makes very small loans to impoverished entrepreneurs in developing countries, will remain stunted.

According to those handing out microloans to entrepreneurs through micro-finance institutions (MFIs) worldwide, it is surprisingly easy. Many MFIs report historical repayment levels on loans of 97 per cent or more. The pride of their impoverished borrowers has spurred strong repayment rates.

Yet trying to establish whether these microfinance institutions themselves are a good diversification play compared with other emerging market asset classes is a rather more taxing task.

Microfinance fund managers have long argued that investments in MFIs are not correlated to broader macro-economic indicators. This would make them more attractive, as they would offer the possibility of non-correlated returns, or "alpha". Now, the authors of an innovative working paper from the Stern School of Business at New York University have attempted this for the first time.

They were sponsored by Developing World Markets, a US-based investment bank and fund manager focused on microfinance.

"Investors obviously didn't like the notion that non-diversifiable risk was generally believed to be low, but that there were no empirical studies demonstrating this. They wanted facts and figures that were just not available at the time," says Nicolas Krauss, who now works at The Boston Consulting Group, but undertook this project when he was doing his masters degree in international politics and international business at NYU under the guidance of Ingo Walter.

Their idea is to compare micro-lenders to commercial banks – for whom much better data is available – operating in the same country. They assumed that six key variables would affect the performance of both microlenders and commercial banks: the change in net operating income; return on equity; profit margin; change in total assets; change in loan portfolio; and change in portfolio at risk.

All of these variables were then compared with global market indicators over that period, and also to the domestic economic performance in the country where each institution was located.

The rationale was that if some of the parameters for commercial banks were significantly more exposed to market movements than they were for MFIs, it would indicate the latter were less exposed to systemic risk.

The study's conclusions, although tentative, and constrained by the limited available data on microlenders, suggest they are less correlated to equity indices than are commercial banks against one or more parameters. They are far less correlated than are comparable commercial banks to domestic macro conditions. Thus they do indeed appear to represent lower country risk than shares in banks.

Private investors have led the charge into commercial microfinance, attracted to financial returns, which can be mid to high single digits, and to the social impact of microcredit organisations. As Robert Weissenstein, chief investment officer of private banking in the Americas for Credit Suisse, pointed out at a recent New York conference where the working paper was presented, "It's hard to separate the financial return from the social return of microfinance investing, but some of this data is very compelling."

Does this mean that private individuals and institutional investors should be allocating more cash to the market? The study supports what has been suggested for some time: **microcredit borrowers are operating in the informal sector, and so they are less affected by shocks to the formal economy.**

Furthermore, during an economic crisis, people are likely to carry on buying staples from the Nairobi market vendor, even if they shun pricier consumer goods in shops. MFIs also tend to offer shorter-term loans on much smaller amounts than commercial banks, with higher interest rates and weekly or bi-weekly repayment plans. All of this lowers default rates.

Feedback to the working paper has been good, and an amended version, with more data and perhaps more analysis of country-specific risk, will be available later in the year.

Another rub is that as MFIs attract more sophisticated international funding or move into commercial lending and begin to resemble their commercial banking counterparts, the portfolio diversification advantages they offer will eventually disappear.

But in the process, maybe they will have helped the bonsai tree of poverty to grow a little.