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Microfinance funds gaining popularity among pension plans

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As the global financial crisis carved its swath of destruction through the world's economies, there were casualties in virtually every asset class. Only a small handful of investment categories emerged unscathed. One such outlier was microfinance, a niche market that, although a relatively new kid on the block, has great potential. In fact, Swiss-based BlueOrchard, an administrator of microfinance products, estimates that over the next five years, between US\$10 and US\$20 billion dollars will be needed to cover the demands of the world's 500 million microfinance customers.

A Nobel prize-winning idea

In 1983, Muhammad Yunus began issuing \$20 "microloans" to some of the poorest members of the Bangladeshi population to provide them with a means of subsistence. The idea was a success. Not only were the vast majority of loans repaid, but a large number of borrowers were able to pull themselves and their families out of poverty.

Twenty-three years after that first \$20 loan, the simple, yet innovative idea earned Yunus and his bank a Nobel Peace Prize for their efforts 'to create economic and social development from below'. The idea has since been implemented with great success in a wide range of developing countries.

A new category of socially profitable investment

Investing in micro-entrepreneurs is not a direct process. Microfinance funds invest money into microfinance institutions, which act as intermediaries and administer the actual loans to micro-entrepreneurs in countries such as Africa, Asia, Eastern and Central Europe and Latin America.

In recent years, since many of these microfinance institutions have continued to experience explosive growth, microfinance private equity funds were launched to respond to the need for equity. According to microfinance specialist Xavier Rielle, worldwide assets in this sector are currently estimated at US\$50 billion.

Many institutional investors—European pension plans in particular—have been looking at microfinance as a new alternative asset class with a long-term investment horizon and have progressively integrated mature microfinance products or funds into their asset allocation. Microfinance funds offer institutional investors a "double bottom line," providing both a financial and a social return.

These funds are used primarily as auxiliary investments in a portfolio. In addition to not being correlated with other investment categories, they are also subject to lower volatility, thanks to their broad dispersion across many countries and sectors. This is demonstrated in the consistency of returns generated by these products in recent years. One of the world's oldest and largest microfinance funds has achieved a cumulative return of more than 60% (in U.S. dollars) since it was launched a decade ago. Even in the face of the market turmoil over the past two years, the returns on many of these collective investment vehicles have been positive, ranging from 2.5% to more than 3.5%.

In 1998, Luxembourg's Dexia Bank created the Dexia Micro-Credit fund, the first commercial investment fund designed to refinance microfinance institutions. Since the fund's inception, there have been no repayment defaults. The target annual return of the fund is the six-month Libor (London Interbank Offered Rate) plus 1% to 2%. This target has been achieved nearly every year since inception, with extremely low volatility. To help secure assets, the fund also keeps a well-diversified portfolio in

terms of the countries in which it invests.

Pension plans and microfinance funds

Attracted by the financial and social returns associated with microfinance funds, the world's pension plans are increasingly taking notice. And while microfinance investing is in its infancy in the Canadian market, the concept continues to demonstrate extremely strong interest and growth in Europe.

In August 2009, the World Microfinance Forum Geneva released a study titled *Ends Meet: Current state and future prospects of European pension funds' investments in microfinance*. The study, which covers 19 pension funds in seven European countries (with total assets of €350 billion), explores their use of microfinance investments as well as their motivations, concerns and attitudes. The total microfinance investments of the group of 19 pension funds stands at €390 million. Investments by single pension funds typically ranged between 0.3% and 1% of total assets, with a high of 3.6%.

Looking at the drivers of investment in microfinance, some pension funds stressed the contribution to corporate social responsibility while others cited primarily financial reasons for investing, such as portfolio diversification and risk-adjusted financial returns. Some of the larger funds were seeking exposure to financial innovation and the related "first-mover" advantage. The most common concerns surrounding microfinance included "uncertainty about the long-term market development of risk, and the limited size of the microfinance market".

Respondents to the study said they were "generally optimistic about the long-term prospects for microfinance investments, despite their awareness of the short-term increase in risk due to the ongoing economic recession." Most interviewees said they expected more pension funds to enter the microfinance investment space in the coming years.

There are also indications that the recent period of financial turmoil could actually serve to strengthen the microfinance industry. The lower volatility, de-coupling arguments and socio-economic impact of microfinance funds will continue to be interesting attributes for investors in the months and years ahead.

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