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## International diversification and Microfinance

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International commercial banks, institutional investors, and private investors have become increasingly interested in financing microfinance institutions (MFIs). This paper investigates whether adding microfinance funds to a portfolio of risky international assets yields diversification gains. By using mean-variance spanning tests with short-sale constraints, we find that investing in microfinance may be attractive for investors seeking a better risk–return profile. Specifically, the analysis suggests that investing in MFIs from Latin America, or microfinance and rural banks yields more efficient portfolios. In contrast, adding MFIs from Africa or microfinance NGOs to a portfolio of international assets is not beneficial for a mean-variance investor.

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### 1. Introduction

About ten years ago, microfinance started to become more commercial, and this commercialization is increasing very strongly. Commercial banks in developed and developing economies play an increasing role in funding microfinance institutions. In Pakistan, for instance, a number of private commercial banks have moved into microfinance. In Malaysia, Nepal, and Thailand there are programs stimulating commercial banks to become involved in microfinance. In India the National Bank of Agriculture and Rural Development (NABARD) has recently initiated a program to involve private banks in microfinance. According to recent studies the growth of microfinance in India is led by a number of

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commercial banks such as ICICI and HSBC together with private venture capital funds and social venture capitalists (Lakshman, 2006; Iyer, 2006).

The commercialization of microfinance has also expanded the traditional services by MFIs. MFIs traditionally focus on microcredit, in the form of small loans to the poor. Currently there is a strong shift from microcredit to microfinance. This broader term reflects the fact that microfinance is not only about providing loans. MFIs also collect savings, provide insurance, and help to distribute and market clients' output (Armendáriz de Aghion and Morduch, 2005). Moreover, new banking technology, such as charge cards, ATMs, the use of cell phones and the internet has begun to enter the microfinance business, helping to reduce costs and improve the delivery of services.

The funding situation of MFIs also starts to change rapidly. Traditionally, microfinance institutions are mainly funded by private and public donors and aid organizations. Recently, international commercial banks and investors have become increasingly interested in financing MFIs. There is an increase in MFIs for which capital market funding becomes important (see Swanson, undated). The first example of commercial capitalization of MFIs was the creation of an investment fund called Profund, which raised \$23 million to finance Latin American MFIs. In 2006, private investment funds, also known as microfinance investment vehicles (MIVs) held portfolios of MFIs' shares with a total value of \$2.3 billion (CGAP, 2007).

Some microfinance institutions have even gone public, and became commercial banks. The most well-known example is Compartamos in Mexico. Compartamos started in 1990 as a standard MFI by providing joint-liability loans to female borrowers. In 1998 Compartamos became a regulated financial institution, a so-called Sociedad Financiera de Objeto Limitado (SFOL). In 2002 Compartamos, as one of the first MFIs, issued public debt. In April 2007 Compartamos went public and transformed itself into a commercial bank. Driven by increasing access to commercial funding sources, the volume of microfinance loans has risen sharply in recent years, from an estimated USD 4 billion in 2001 to approximately USD 25 billion in 2006 (Deutsche Bank Research, 2007).

Since most MFIs are not deposit-taking institutions and since domestic capital markets are thin, international capital markets will become more and more important for the future funding of MFIs. In the 2004–2006 period, foreign investment in Microfinance already more than doubled, from USD 1.7 billion to around USD 4.4 billion (Deutsche Bank Research, 2007). Approximately 50 percent of the funding of foreign capital to MFIs is channeled through specialized Microfinance Investment Vehicles (MIVs). The number of MIVs has increased rapidly and there are now over 80 in existence MIVs. The main investors in MIVs are individual investors. The share of international financial institutions in MIV funding has declined from 36 percent in 2005 to 30 percent in 2006, while institutional investors are catching up. Since 2004 institutional investors have been expanding their interest in the microfinance industry. There is especially an increasing interest from pension funds to invest in microfinance. An example is the launching of the Institutional Microfinance Fund of the Dutch retail bank SNS, which is almost entirely funded by Dutch pension funds.

To some extent the trend of increasing interest of private and institutional investors for microfinance can be explained by the increased attention for socially responsible entrepreneurship. However, institutional and private investors are also attracted by the high returns provided by some microfinance institutions. Moreover, as is argued by e.g. Krauss and Walter (2009), microfinance may provide attractive opportunities for portfolio diversification since the risk adjusted returns exhibit low correlations with other assets. This low correlation may be due to the fact that many clients of microfinance institutions are part of the informal economy, which is less sensitive to macroeconomic cycles. This suggests that investing in microfinance could offer diversification benefits to (institutional) investors seeking to reduce their portfolio volatility. In the academic literature, however, we find surprisingly little rigorous testing of this issue.

This paper investigates whether domestic microfinance institutions to a benchmark portfolio of international assets is beneficial for investors by using a mean-variance spanning test. This methodology has been used in several seminal papers studying benefits of international diversification, especially in the context of emerging markets, see e.g. Bekeart and Urias (1996), and De Roon, Nijman, and Werker (2001). The spanning methodology has recently also been used to analyze the harmonization of fiscal and economic policy within the European Monetary Union, see Moerman (2008). We are the first using mean-variance spanning tests to examine benefits of investing in MFIs.

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