WHITE PAPER
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WHY MICROFINANCE MATTERS TO INVESTORS

The big picture narrative behind the industry's success

symbiotics

This paper was written by Christoffer Dahlberg and Roland Dominicé in late 2016 and early 2017. Its intent is to share experience on years of exchange with private and institutional investors in microfinance, and the role the topic plays in a global portfolio context. It was proofread by David Grimaud and Valérie Dujardin. The publication was coordinated by Ramkumar Narayanan and the paper was designed by James Atkins Design Ltd.

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CONTENTS

1	A STEADY TREND FOR TWO DECADES	1
2	GLOBAL CHALLENGES	5
2a	Population Growth Asymmetry	6
2b	Economic Growth Asymmetry	9
2c	Banking and Credit Markets Asymmetry	10
2d	Interest Rate Asymmetry	13
3	INVESTMENT SOLUTIONS	17
3a	Optimizing Risk-Adjusted Portfolio Performance	19
3b	Enabling Social Progress at the Base of the Pyramid	22
3c	Promoting Employment and Entrepreneurship in the Missing Middle	25
3d	Achieving the 2030 Sustainable Development Goals	28
4	KEY TAKEAWAYS	31

LIST OF ACRONYMS

CGAP	Consultative Group to Assist the Poor
EU	European Union
EUR	Euros
GBI	Global Bond Index
GDP	Gross Domestic Product
GIIN	Global Impact Investing Network
HFR	Hedge Fund Research, Inc.
IFC	International Finance Corporation
IFS	International Finance Statistics
JPM	J.P. Morgan
MFI	Microfinance Institution
MIV	Microfinance Investment Vehicle
MSCI	Morgan Stanley Capital International
MSME	Micro-, Small and Medium Enterprise
NIRP	Negative Interest Rate Policy
PPP	Purchasing Power Parity
SDG	Sustainable Development Goal
SME	Small and Medium Enterprise
SMX	Symbiotics Microfinance Index
SRI	Socially Responsible Investing
UN	United Nations
USD	U.S. Dollars
ZIRP	Zero Interest Rate Policy

1

A STEADY TREND FOR TWO DECADES

Although being the oldest and most established asset class in the field nowadays referred to as *impact investments*, defined as investments targeting both a financial and a positive, measurable social return, microfinance has only come of age over the last two decades – with its first private sector investment funds launched in the mid-1990s. Ten pioneering Microfinance Investment Vehicles (MIVs) were setup between 1992 and 1998, all attracting foreign private sector capital. Combining a financial with a social impact return, each fund weighed the two return streams differently and the investment rationale therefore varied between investors. By 2005, 47 MIVs had been set up, with a growing common understanding on the double bottom line of the investment case.

When Symbiotics won its first institutional investment mandate ten years ago, there was little in the form of tangible statistics to go on to prove the validity of the asset class, neither from a financial, nor from a social perspective. Today the investment case is supported from both angles by a variety of research sources, and the frequently used description that investors in microfinance are 'doing well by doing good' has been confirmed.

At the beginning it was international financial institutions, public sector development banks and agencies that took on the role as angel investors in microfinance and still today, they remain anchor investors for specialized fund managers. Over the last decade they were complemented first by high net worth individuals, private bankers and independent wealth managers, who brought the first private sector capital to the asset class, understanding the economic opportunity. Later, thanks to the removal of certain regulatory constraints, retail investors, small savings and deposits accounts started to take an interest in microfinance funds. Finally life insurance groups, pension plans and corporate treasuries joined the growing investor circle, convinced by the financial rationale and investment logic. They may have been last to the party but today they make up the largest category of investors in the asset class. What all these various types of investors have in common is that they are all compelled by the microfinance investment story, its dual return stream and its multiple explanatory factors.

Microfinance investors of all backgrounds have nourished a steady trend, both validating and benefiting from its success, continuously investing and reinvesting in this growing niche. Foreign investment fund assets have enjoyed a 20% compounded annual growth rate since the United Nations year of micro-credit in 2005, reaching over USD 11 billion in size today. The financial institutions they invest in have grown even faster: the microfinance institutions (MFIs) Symbiotics works with have witnessed a 27% compounded annual growth rate in assets and 23% in end clients over the past decade. More importantly, they have evolved and become more sophisticated, providing payments, savings, insurance and mobile solutions but also diversifying the credit range from household consumption and small business lending into education, agriculture, housing or energy loans. Foreign investors in microfinance have most astonishingly contributed to a growth of end clients directly financed from 500,000 ten years ago to 24 million today. This development towards greater global financial inclusion will certainly continue in the coming decades.

This being said, some things have not changed for microfinance investors over the period. Just like ten years ago, investors still finance the bottom of the social pyramid – with average loan amounts to end clients unchanged at around USD 1,500. They finance primarily women – around two thirds of end clients over the decade. They finance mostly rural borrowers – around half of end clients. They continue to face very low credit risk default rates on their investments, with average risk provisions at 2.0% and average loss write-offs at 0.5% per annum. Finally, investors have seen a steady return on their investments at a net average of 3.3% in absolute terms both in EUR and USD over the past decade. The performance variance has been very low, remaining in a bandwidth of Libor +1 to +4.5% since 2008. Investors have thus benefited from a double steady trend both in terms of growth of their underlying markets and stable above money market absolute returns, with little volatility or correlation to other asset classes. Their decision to invest was based on this steady track record, but also on the rationale behind this success and the new big picture narrative emerging in the global economy [1].

A combination of factors will contribute to a new investment paradigm over the coming decades. To name but a few that will be further explored in this paper, strong demographic growth currently happening in emerging economies does so in an environment of severe lack of capital and financial services; credit markets in the Northern hemisphere are low-yielding and saturated whereas those in many emerging markets are still offering market-priced yields; and global internet connectivity will open the eyes for all both in the global South and the global North to the aspirations and living standards of one another. Whether due to these or other factors, no investor portfolio is immune to these global changes, but can indeed profit from them.

This text reviews these sources of attraction for microfinance investors. It starts by reviewing the global challenges affecting our pensions and savings in developed markets and further offers perspectives on how we look at the emerging world, as a solution to our challenges rather than a source of concern.

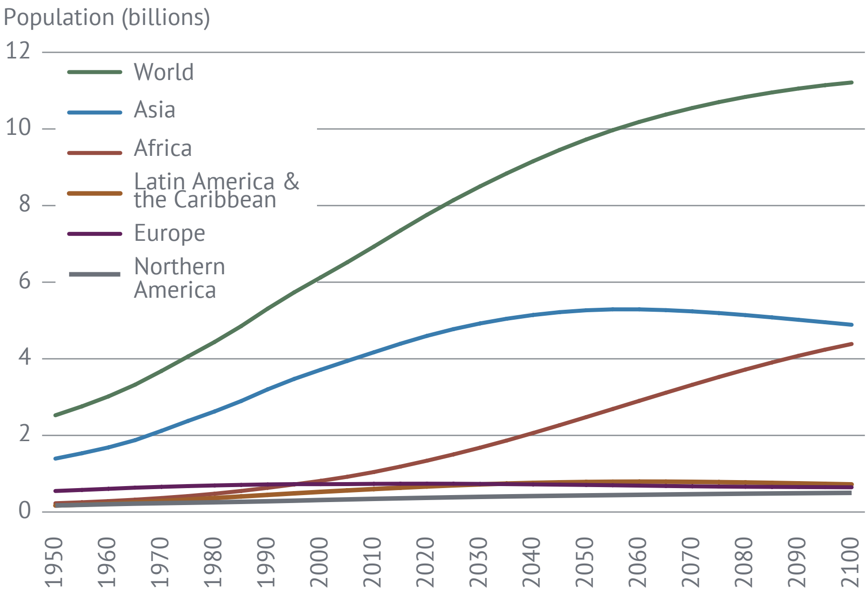
1 Source: All data in this section from 'Microfinance Funds, 10 Years of Research and Practice'; CGAP/Symbiotics; December 2016.

2
GLOBAL CHALLENGES

2a POPULATION GROWTH ASYMMETRY

At an average reading speed, it will take you no more than 3 seconds to read this sentence. Yet at the same time, the world's population will have grown by 7 people. That is one way of illustrating the population explosion currently happening across the emerging world. By current estimates, this overwhelming variable for sociological and economic development will bring the global population to around 10 billion people by 2050, meaning a net growth of 3 billion people over the coming 35 years[2]. That equals a net daily growth of around 200,000 people, every day between now and 2050. Although not statistically certain today, it is probable that the global population continues to grow beyond that, albeit at a lesser pace.

One reason this is not widely debated across Western news channels is that it does not occur in our part of the world. Unlike in the 20th century, European and North American populations will decline between now and 2050, and Latin America will not grow beyond current population numbers. Asia on the other hand will grow by 1 billion to reach 5 billion. The African population will more than double until 2050, growing by 1.5 billion to reach 2.5 billion. Whereas current projections show a stabilization in Asia thereafter, estimates give at hand that Africa will continue on its growth path towards a population of 4 billion by 2100. If correct, 90% of the world's population would by then live in Africa or Asia.



Population Projections by Region: The demographic wave in the emerging world

(Source: The United Nations: 'World Population Prospects, the 2015 Revision')

2 United Nations DESA report, 'World Population Prospects: The 2015 Revision'

In parallel, due to increased life expectations and lower birth numbers, a structural shift in the population of developed economies will occur. The projected old-age dependency ratio, i.e. retirees as a percentage of working-age population, will grow from 29% in the European Union (EU) today to 49% by 2050. In Europe's largest economy, Germany, the ratio will increase by almost 25 percentage points to 57% by 2050[3]. In the United States the evolution is more favorable with a 10 percentage point increase to 32%, whereas in Japan where the ratio is already today at 44%, it would increase to a whopping 75% by 2050 if projections hold true[4]. The Japanese population is in fact projected to decrease by a dramatic 20 million people, or more than 15%, by 2050[5].

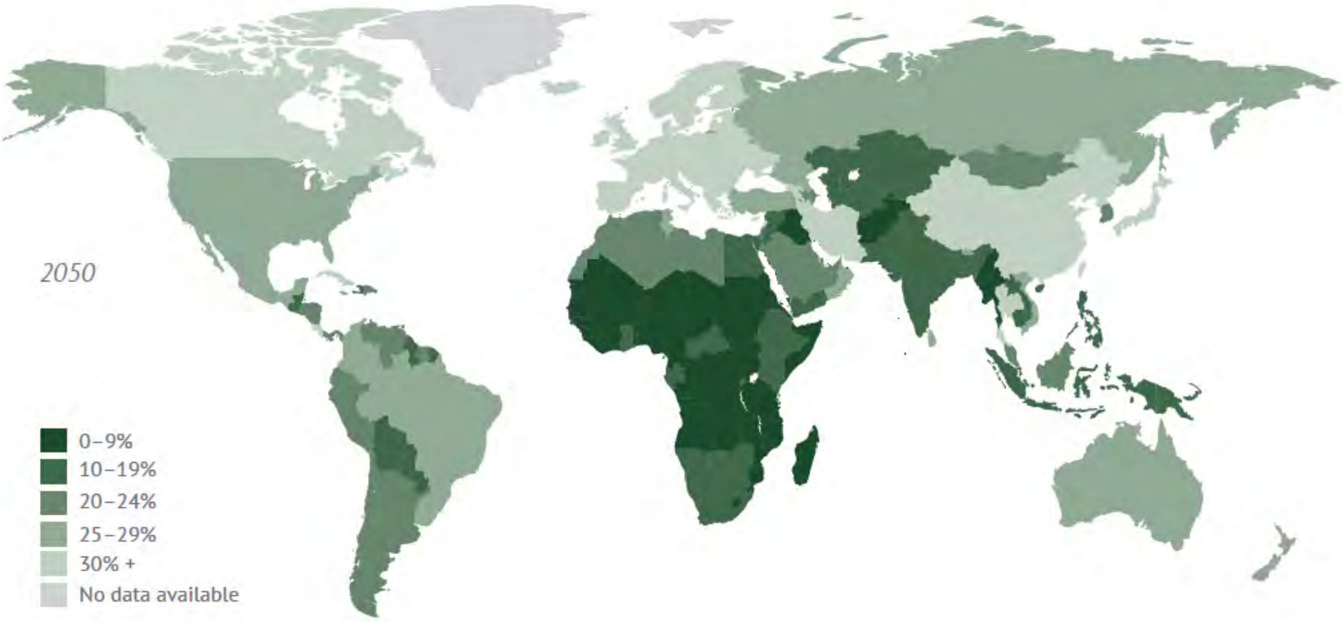
Immigration policies are a force that can improve or lead to a further deterioration of these numbers. An example however clarifies the challenge at hand: assuming the population of the EU remains stable at the current level of around 500 million between now and 2050 and all other things remain equal, maintaining the current old-age dependency ratio at 29% would require an immigration of around 100 million people in working age over the coming 35 years. And even if Europe were to achieve that undoubtedly daunting task, 100 million are less than 10% of the projected population growth in Africa over the same period. It quickly becomes clear that although necessary, migration towards the Western hemisphere will by far not be enough to address the demographic challenge the world will face over the coming decades, and that far more ambitious targets and policies focused on developing emerging markets from within are called for today if we want not only to maintain, but also to improve the global living standard by 2050.

Evidently the demographic explosion will also have vast implications for investment and portfolio management decisions for various types of investors. Therefore, whether at political, policy-making or investor-level, anyone who fails to take the demographic evolution across the emerging world into account in his policy or investment decisions will miss the next major wave of the global economic development, with potentially dramatic effects on a political, wealth and retirement planning level.

3 Eurostat
4 OECD
5 United Nations Department of Economic and Social Affairs

Proportion of Population Aged 60 or Over in 2015 and 2050

(Source: United Nations, Department of Economic and Social Affairs, Population Division (2015). World Population Prospects: The 2015 Revision)



Top 20 Growth Countries 2016–2021

Mozambique	13.1%
Libya	9.4%
Bhutan	8.3%
Brunei Darussalam	7.8%
Myanmar	7.7%
India	7.6%
Ethiopia	7.4%
Côte d'Ivoire	7.4%
Lao P.D.R.	7.4%
Rwanda	7.1%
South Sudan	7.0%
Senegal	7.0%
Cambodia	6.9%
Niger	6.8%
Bangladesh	6.8%
Mongolia	6.7%
Tanzania	6.6%
Djibouti	6.6%
Kenya	6.4%
Philippines	6.4%

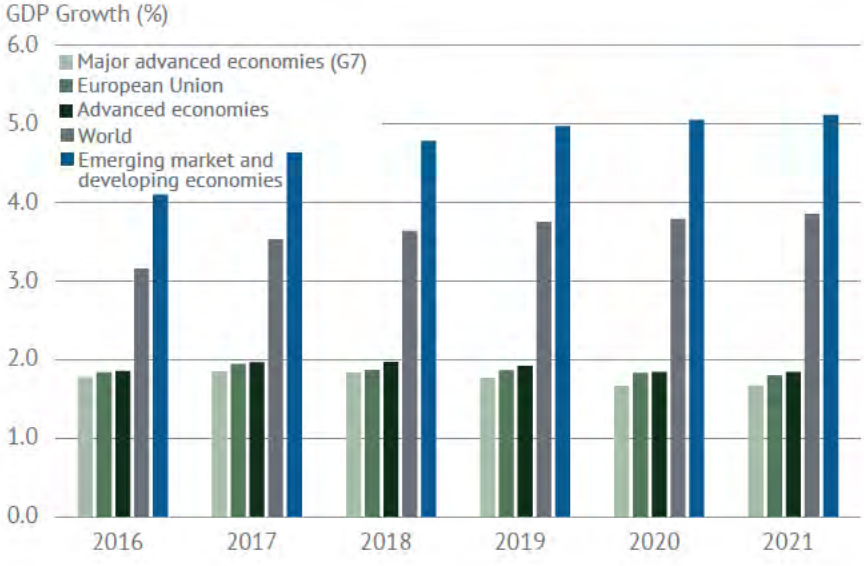
2b ECONOMIC GROWTH ASYMMETRY

The global demographic evolution will shift the center of global economic growth from more developed nations to low income economies. There is not a perfect correlation between population and GDP growth, with many other factors influencing economic output as well. These include healthy governance and politics, social justice and protection systems, promotion of technology transfers and infrastructure development. All these factors are fundamental in the longer term, but all other things equal, countries seeing a population growth of 3-4% a year, as is today the case in many African countries, will eventually see stronger economic growth than countries where the population is shrinking. It is thus no surprise that in the top 20 GDP country growth forecasts over the coming decade, almost all are located in Africa and Asia. In contrast, forecasts for OECD nations are much lower across the board, in some cases even flat or negative.

Economic growth is a vital factor in wealth planning from a 10- or 20-year perspective. For short term investors, other factors less tied to longer trends come into play as well, but for investors with longer time horizons, such as life insurance companies, pension funds or even private investors, long-term trends in economic growth and value creation are critical. Historically this task was easy, as growth and value creation was found in ample supply in, or close to, the home countries of Western investors. In the 'new' world now developing, this will no longer be the case. More than ever before, investment approaches therefore need to have a broad and evolving perspective, both geographically and in terms of investment themes.

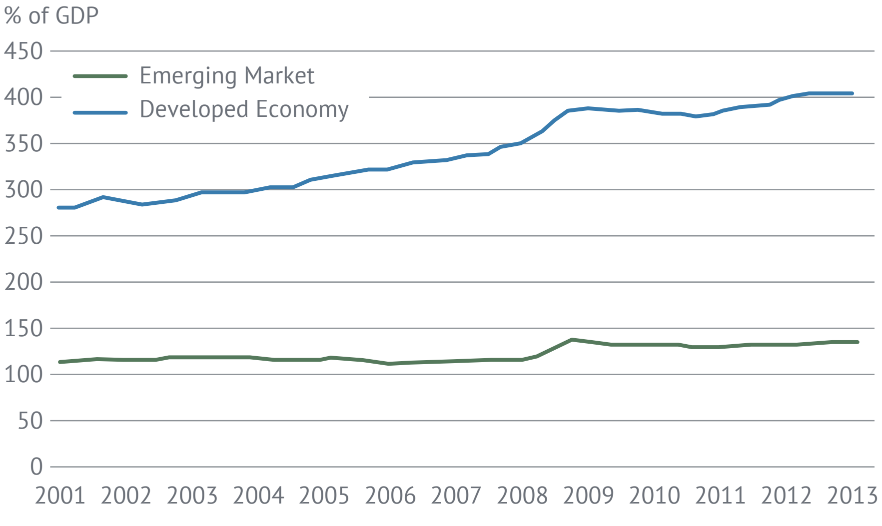
Annual Growth Projections 2016-2021: Growth today happens elsewhere

(Source: International Monetary Fund, World Economic Outlook Database, April 2016)



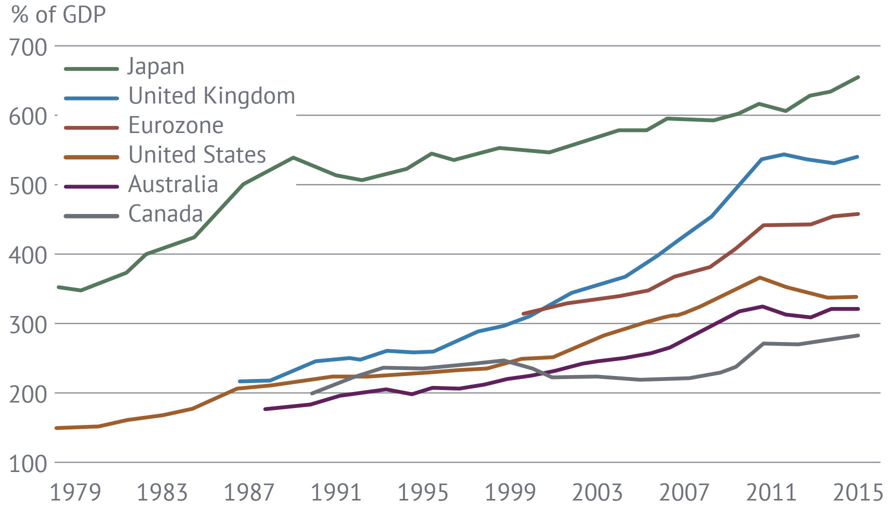
2c BANKING AND CREDIT MARKETS ASYMMETRY

Against a backdrop of an ageing workforce and slower economic growth, both public and private debt levels have increased in developed economies. In the current environment of low to negative interest rates and unchanged high savings rates, the (over) indebtedness that has built up can still be supported. Unfortunately however, large portions of the accumulated debt are used to sustain established consumption patterns and do as such not support new, income-generating activities. With banks unwilling to provide business financing, the existing trend of lackluster growth and limited economic opportunity is reinforced. It is therefore not surprising that investors increasingly turn towards the emerging world with its combination of healthy business and income generating activities, low levels of indebtedness and immense opportunities for economic development and financial inclusion.



Developed vs. Emerging Market Debt: Average total debt (household, government, non-financial corporate, financial) as % of GDP

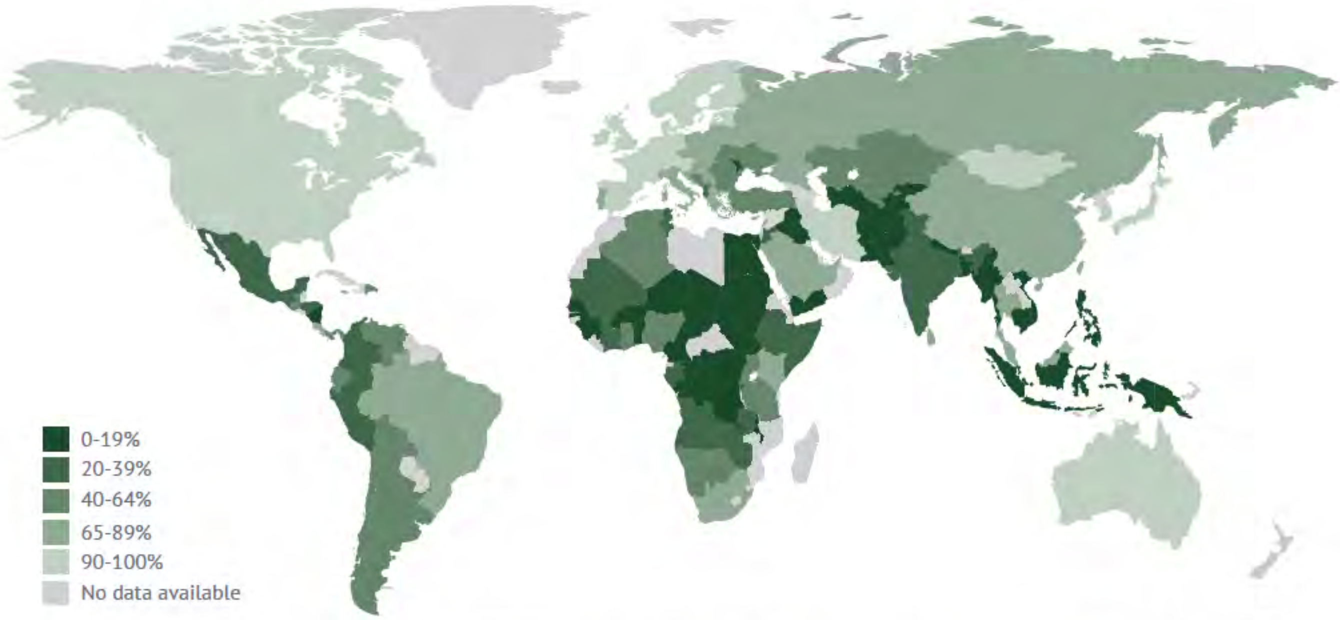
(Source: McKinsey Global Institute, WSJ.com)



Total Public and Private Debt as % of GDP of Major Countries

(Source: Bank of Japan, Cabinet Office, Statistics Canada, Federal Reserve, Bureau of Economic Analysis, Office of National Statistics of U.K., Statistical Office of the European Communities, Reserve Bank of Australia. Through Q1 2013)

Percentage of Adults with an Account at a Financial Institution



In the darker green parts of the map, less than 65% of the adult population have access to reliable and regular financial services (Source: World Bank Global Findex 2014)

Contrary to developed countries, microfinance target markets are largely underbanked. Indeed, the reason microfinance has developed strongly in many of these countries is that in environments where the population and small businesses lack access to capital, microfinance provides financial solutions and tries to bridge the financing gap. In certain African and Asian countries, over half the adult population have never been in contact with a bank, nor held a credit card in their hand. They do not benefit from insurance protection, the security of a savings account or the facility of payment systems.

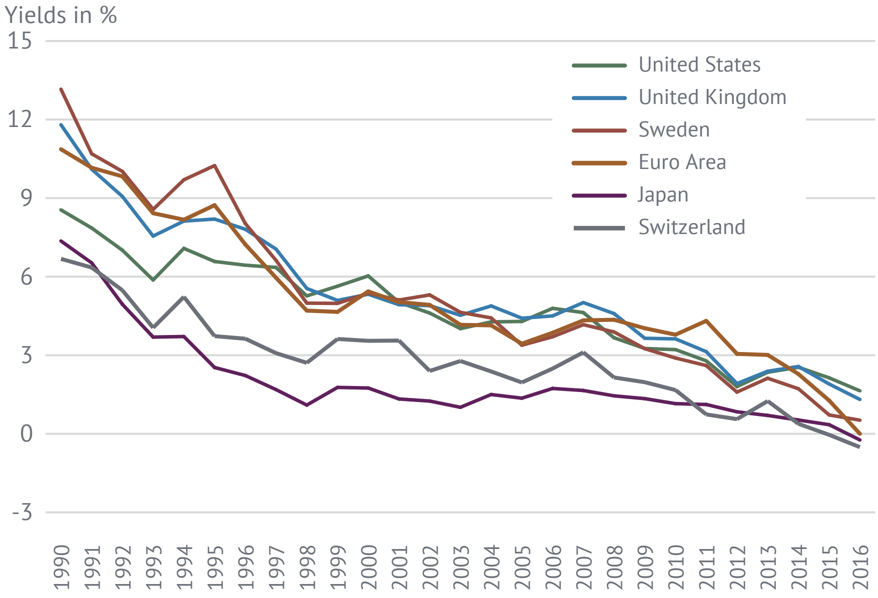
According to standard theory of efficient capital markets, excess savings flow to projects in deficit of capital. Adam Smith's *invisible hand* automatically and rationally allocates excesses to deficits, through unintended private self-interest ambition. This is not really occurring on a global scale, where markets are in fact far from being efficient. Rather than seeking opportunities across the emerging world, saturated Western financial markets to a large extent instead remain inward-looking in terms of capital flows. Fortunately however, investors, supported by globalized financial markets allowing for greater capital flows between the North and the South, are becoming increasingly aware both of the necessity to push capital where it does not normally flow and of the attractive economic opportunity associated with doing so.

2d INTEREST RATE ASYMMETRY

The introduction of zero and negative interest rates policies (ZIRP-NIRP) in developed economies have brought with them a new market paradigm and reinforced the trend towards over-indebtedness, further impairing growth prospects. The recovery since the 2008-2009 financial crisis is the weakest in modern history and there is little proof, neither academic nor practical, that ultra-low interest rates have done more to support the recovery than provide artificial breathing for unsustainable, 'zombie' businesses and banks. Yet politicians and central bankers continue to support negative rates, hoping to increase the credit appetite and thereby consumption and business development. In certain economies the interest rate regime is additionally supported by protectionist policies serving to prevent an excessive currency appreciation through a global flight to quality. This latter phenomenon has its root in the scarceness of investment opportunities among developed economies and hereby a flight towards the most advanced nation. The problem is further reinforced in volatile times when investors pull money out of high-growth regions and repatriate it domestically.

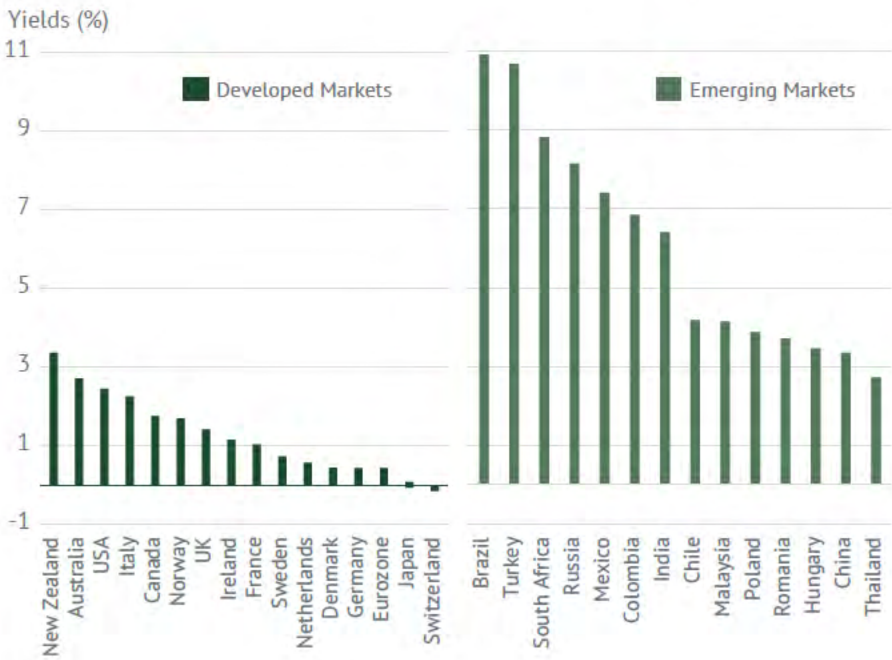
Government Bond Yields – Long Term: A race towards the bottom

(Source: International Monetary Fund, International Finance Statistics (IFS) Database, 2016)



In the ZIRP-NIRP paradigm, the real value of money is lost for investors: borrowers indebt themselves for free and savers are punished by being 'taxed' on their wealth through the absence of interest rates. Policies of persistently cheap credits induce not only a culture of over-indebtedness, but also provide life support to unprofitable businesses; they support projects and endeavors that would in normal conditions never see the light. As investors are forced to excessive risk-taking that is not commensurately remunerated, the sanctioning of a healthy savings behavior reinforces a spiral of deflation, consumerism and increased risk for the longer term security of households.

Investors with a long-term vision and understanding of the relationship between the real economy and financial markets, as well as of globalization trends and socio-economic dynamics in the emerging world, are today screening investment opportunities and products that target such needs and opportunities. They understand that holding cash in a non-income generating environment is unproductive and does not create any value, and that injecting further capital in already saturated markets in countries with ageing populations may reinforce negative trends. They also understand that alternatives exist, and that by pushing money where it does not normally flow, into economies benefiting from large and rapid population growth, strong production and consumption demand, but with large deficits in access to capital, they help their portfolio performance. These investors grasp the need for a much broader investment approach than one that only relies on developed countries in order to sustain their wealth and grow their capital.



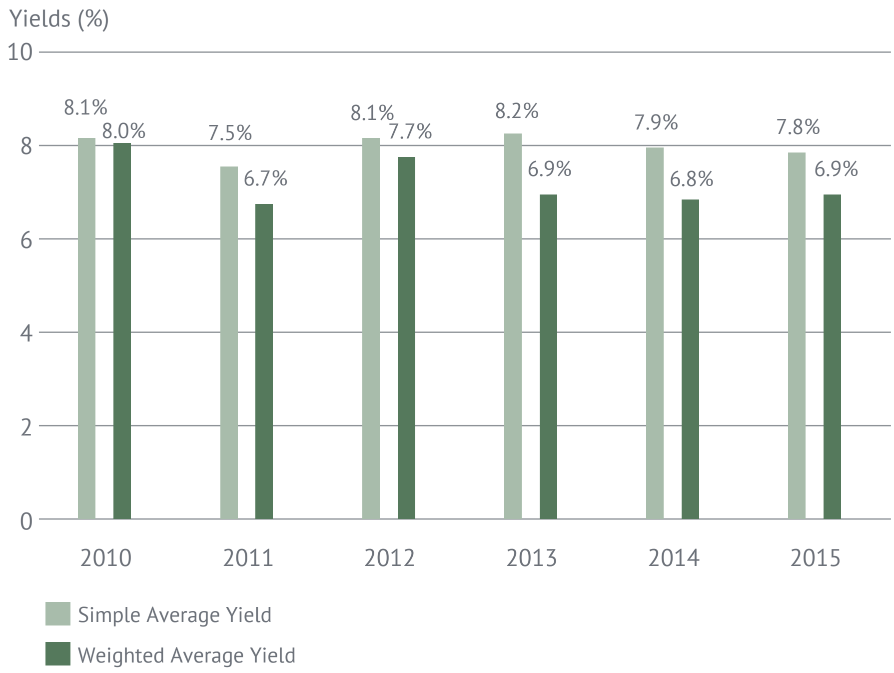
10 Year Government Bond Yields: Although lower than a few years ago, yields in the emerging world remain positive, although investors obviously need to keep exchange rate and other related risks in mind

(Source: Bloomberg; Generic 10-year Government Bonds, Data as of January 31st, 2017)

Most emerging and frontier markets are correlated to developed markets in the sense that they have also seen falling interest rates. Yet in most cases their credit markets still function properly, with positive real interest rates and borrowers paying rational credit premiums on debt, as illustrated in the graph on p14. As further illustrated below, in the case of microfinance, fundamentals are even more attractive and portfolio yields have only seen a modest fall in the last six years. This reflects the very high capital deficit of the base of the pyramid and the very high growth rates of the intermediaries addressing its needs; their demand not only continuously remains above capital supply but also generates healthy profits based on healthy underlying fundamentals.

Historical Simple and Weighted Average Yield on Direct Microfinance Debt Portfolio: Microfinance still generates stable yields

(Source: Symbiotics 2016 MIV Survey Report)



3
INVESTMENT SOLUTIONS

In the new paradigm shift the global economy is facing, more advanced economies may increasingly face declining populations, flat growth perspectives and negative interest rates. But the new generations also face a paradox as they are able to cumulate very large amounts of wealth per capita, remaining professionally active much longer than their parents and grand-parents. Additionally, with appreciation pressure on their home currencies and low- to no financing cost, their wealth is structurally meant to continue growing. This happens alongside growing deficits and over-indebtedness, which counterintuitively reinforce the spiral further. In parallel, the current working generation in the developed world is an opposite replica of the base of the pyramid in emerging and frontier markets, which sees strong population and economic growth, but where still often half of the adult population lacks access to finance and live in countries with very limited corporate or sovereign financing markets, logically inducing higher interest rate expectations.

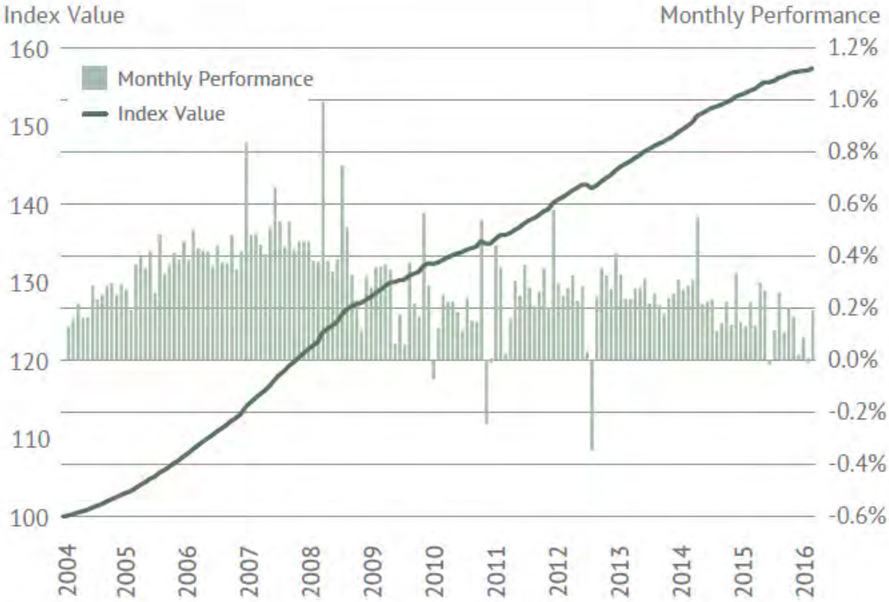
These dynamics can develop side-by-side in an unsustainable manner – until one day they break onto themselves. Alternatively, which seems more likely and certainly more desirable, they can join forces in a globalized world and thereby unlock a virtuous win-win cycle. Massive capital savings can flow out of saturated markets into highly underserved and growing markets, positively rebalancing developed financial markets and generating a strong and lasting financial sector development in developing countries. If approached with the right objective and strategy, this financial inclusion at the benefit of the Global South will not only benefit the investment portfolio performance of retirees, insurers and private wealth managers of developed economies, but also induce improved social progress, better employment opportunities and stronger private sector development in emerging markets. Overall, it will thus provide a number of positive contributions to United Nations' Social Development Goals (SDGs), on which we will elaborate further in Section 3D below.

3a OPTIMIZING RISK-ADJUSTED PORTFOLIO PERFORMANCE

The common view of investments in emerging markets as being volatile and unpredictable is largely driven by rapid capital flows induced by foreign investors and motivated not by the development of the market they are invested in and repatriated from, but rather by factors in investors' home markets. This means that traditional investments in emerging markets typically also exhibit significant correlation to other asset classes and global market developments. Private equity and private debt products, which by definition offer less liquidity and thereby less possibilities for repatriation, tend to capture the underlying value of emerging economies better. This is also true for investments in microfinance, something an increasing number of investors have noticed over the last decade.

Microfinance debt investments are not marked to market, being typically structured as untraded, private loans. If the underlying currency exposure is hedged, volatility is driven solely by defaults, of which well-managed portfolios have very few. Bad loan default rates peaked in 2010 and 2016, due to global and emerging market crises in the previous respective years, but have remained low, at 5.0% in peak year and below 2.0% on average. As one of the largest foreign debt providers in the industry, Symbiotics has for example a loan write-off rate cumulated over 12 years of only around 1% on a total loan volume exceeding USD 3 billion, across more than 70 markets and 3000 transactions. Low default rates produce a remarkably steady return stream as is illustrated by the Symbiotics Microfinance Index (SMX-MIV Debt USD), a reference benchmark calculated since 2003 on the average performance of the largest microfinance fixed income funds in the industry, hedged in USD[6]. Between 2003 and 2016, a period of around 150 months, the index has produced a positive return in all but three months, with its largest drawdown limited to 0.3%.

6 Source: SMX-MIV Debt USD index information is available on Syminvest.com



SMX-MIV Debt Index: The first rule of successful asset management is avoiding drawdowns

(Source: Symbiotics Research, Data per End December 2016)

Adding the index as a proxy for microfinance to a basket of more traditional asset class indices, representing an equal portion of cash (Libor 3 months USD), bonds (JPMorgan GBI), equity (MSCI World) and hedge funds (HFRX), the portfolio risk is lowered whilst the performance improves slightly. This holds true also for most other weightings of the above proxies, not to mention portfolios also including a long exposure to commodities in recent years. It can therefore be claimed that for most portfolios, an allocation of microfinance improves the risk-return profile.

Microfinance vs. Other Asset Classes: Low volatility leads to superior risk-adjusted returns

(Source: Symbiotics Research, Data per End November 2016)

SMX-MIV USD Debt Index (2003-2016) Against Other Mainstream Asset Classes: Low correlation furthermore provides strong portfolio diversification features. Asset class numbers are based on proxy indices used in the previous graphic

(Source: Symbiotics Research, Data per End November 2016)

Asset class	Correlation
Cash	0.56
Bonds	0.03
Stocks	-0.11
Alternatives	-0.14
Commodities	0.01

As earlier illustrated, the interest rate deterioration seen across both developed and emerging markets has affected interest rates in microfinance to a much lesser degree, testifying to the de-correlation benefits of the asset class. As should be the case in a well-functioning market, measured over the last decade, premiums paid by microfinance institutions (MFIs) for their

USD equivalent financing is in line with their risk profile and typically vary between 3 and 9% depending on the size and credit quality of the institution. The credit risk of microfinance loan portfolios are typically BBB domestically in countries with a BB sovereign rating, on average. Added together, depending on sovereign and corporate risk correlation assumptions, this would trigger a B rating. With an average around 6.0% in portfolio yield, this confirms the risk adjusted return of such investments.

Be it for the long-term economic and demographic rationale, the more short-term need to find alternative sources of portfolio yield, or for the actual benefits as a tool for portfolio diversification and improved risk-adjusted returns, microfinance funds have given investors an interesting investment alternative that is increasingly being considered as part of their asset allocation. Most importantly, they have contributed to open up the thinking in current mainstream portfolio management, proving the validity and attractiveness of private debt investments directly into the real economy of underserved, fast growing markets. They thus additionally attract investors by proposing an economic development driven by sustainability principles, seeking a fair treatment of stakeholders along the financing value chain.

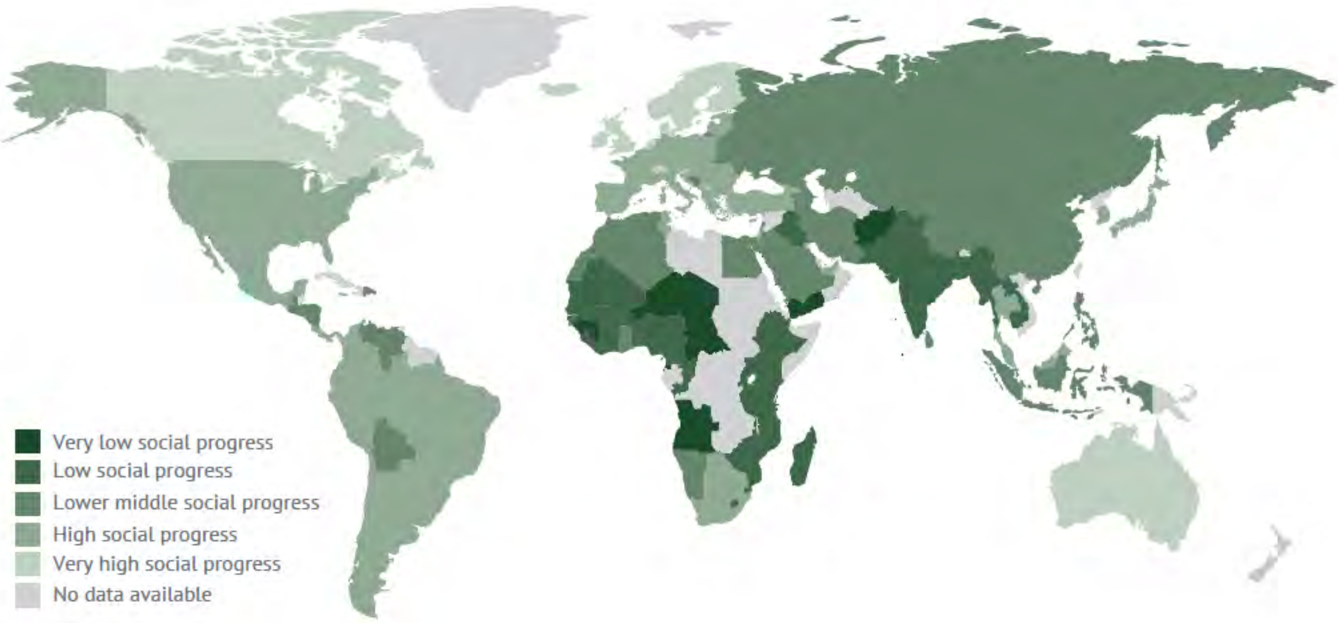
3b ENABLING SOCIAL PROGRESS AT THE BASE OF THE PYRAMID

The vast majority of the net new 3 billion people until 2050 will be born in low income households in low income countries. That creates additional challenges to the global security and economy, both in terms of expectations of new world citizens and in terms of effects on the developed world.

Just like poor people today, every single one of the newborn will have a legitimate claim to access not only goods and services of first necessity, but also a natural aspiration to strive for and fulfill private and professional projects. Taking into consideration a parallel trend, namely that already by 2020 it is estimated that 90% of the world population will have internet connectivity at a speed comparable to developed economies today, it is clear that by 2050 there will no longer be any secrets in terms of what those legitimate aspirations consist of. Indeed it is conceivable that the digital revolution, of which we are only at the start today, will by then have transformed the world in ways difficult to imagine. Still, whatever this transformation will look like, it is doubtful that it can do without a need for good governance, functioning infrastructure and social protection, as well as efficient access to financial services. Logically therefore, all our future to a certain extent depends on the successful development of these critical factors across the emerging world. Investors have an active role to play in this challenge by being conscious of the impact of their investment decisions.

Levels of Social Progress around the World: The uneven status of current social progress across the world

(Source: Social Progress Imperative (2016). 2016 Social Progress Index. Retrieved from www.socialprogressimperative.org/global-index/)



High income disparity is however not only a global but also a domestic national phenomenon, and one that is very present in emerging countries. Poverty is an absolute concept in terms of basic needs for food, shelter and security, but a relative concept in relation to your neighbor. Combined with the digital revolution and global internet access in the coming decades that will make it painfully clear and visible for poor people in emerging markets what living standards resemble in other parts of the world, it can safely be assumed that the pressure to reach higher accelerates and becomes much more pressing – and visible – than in the past. This pressure is the bedrock both for social strife at home and immigration abroad. On the other hand, and as a consequence, as social progress is highly correlated to economic development, there is a strong incentive to catalize the latter in order to trigger the former.

Social Progress Index vs. GDP per Capita: The strong correlation between GDP per capita growth and social progress

(Source: Social Progress Imperative)

Investors increasingly understand that the solution to these tremendous challenges does exist, but is not necessarily found through foreign aid and government intervention. Rather, it is their private savings and investment portfolios that can both profit financially from allocating capital towards new markets, and in parallel help stimulate local economies and enterprises in places with large development potential, promoting initiative and employment. For many young people in frontier markets, it is only when their home country

7 An international dollar would buy in the cited country, a comparable amount of goods and services a U.S. dollar would buy in the United States. Source: World Bank database

reaches a sufficient level of development, supported by the appropriate financial infrastructure, that a life at home becomes a viable alternative to immigration to wealthier regions.

Over the last decade, microfinance portfolios have proven to support local market development and real economy needs to the great satisfaction of investors often frustrated by other types of emerging market investments. The main reason is the significant difference in allocation between microfinance and traditional emerging market debt portfolios. Looking for example, at Latin America, traditional investments will mostly be directed to sovereign, quasi-sovereign or corporate debt across a few large countries, such as Colombia, Mexico or Brazil. By contrast, a corresponding microfinance portfolio will invest predominantly in frontier economies such as Bolivia, the Dominican Republic, Ecuador, Nicaragua and Paraguay, not doing so through sovereign or corporate bonds, but rather directly targeting the base of the pyramid, reaching out to micro-, small and medium enterprises as well as directly low- and middle-income households. It will hereby create an income stream that is uncorrelated to traditional emerging market debt and, by investing in the real economy, directly benefits the local population.

By pushing money where it does not normally flow, into low income economies and households, microfinance investors empower the base of the pyramid population and provide financial inclusion tools that allow businesses and families to grasp economic opportunities, build their own growth and security, and thereby contribute to a more distributive and egalitarian global economic development. Microfinance investors do not own any downstream social progress themselves – that remains a task and opportunity controlled by end clients of microfinance institutions. However, through their capital flows, they enable it in a way that has not been available in the past and is still not accessible today in many regions.

Microfinance investors thus have a double relief from a global capital allocation perspective. First, they do not add further to the saturation of domestic financial markets, where social progress is well advanced and less in need of further marginal capital injections. Second they contribute to the social function of finance in underserved markets by providing capital resources and financial services to valuable real economy needs, where the marginal effect is the highest. Through their actions and responsible behavior they also demonstrate the limitations of efficient market theories, being rather conscious of the social power of their investment decisions. And through these same decisions, they actually improve their portfolio volatility and long term risk-adjusted performance perspective, as previously illustrated.

3c PROMOTING EMPLOYMENT AND ENTREPRENEURSHIP IN THE MISSING MIDDLE

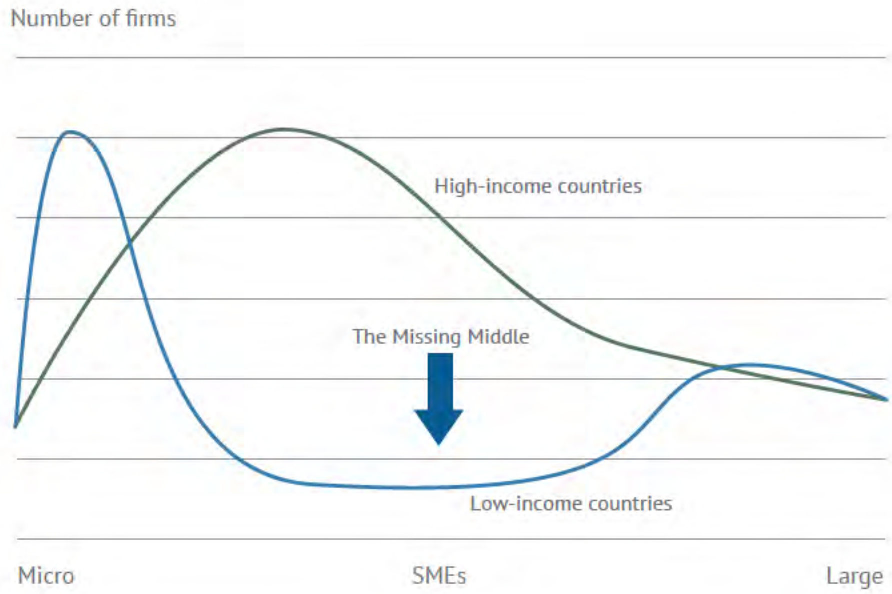
Micro-credit is first and foremost an activity supporting a small income generating activity, that in turn helps low income households purchase goods and services of first necessity to improve their daily living standard. Borrowers are often self-employed or run a business within the family. One family member might have a regular job or other activity, and another might start a complementary revenue stream for the household, whether in agriculture, trade, manufacture or service, and be supported by a working capital micro-loan. Such credits also serve as a credit line for unforeseen expenses and have the additional benefit of linking the family to a bank account, payment system, insurance plan or other type of financial inclusion tool.

As part of their strong growth, microfinance institutions have over time embraced financial inclusion on a larger scale, broadening their offer beyond traditional credits to include for example savings and payment and insurance systems. The offer has also evolved within credit products into areas such as housing, education and other household needs. Eventually the microfinance institution itself develops up-market towards small- and medium-enterprise (SME) financing, defined broadly as 5 to 50 employees and 50 to 250 employees respectively. SME financing is a full component of financial inclusion and an area that most microfinance funds and investors have embraced as a growing part of their portfolios.

When asked about the biggest impediments to growth, almost half of SMEs in low income countries cite access to finance as a major constraint[8]. And when low income households are asked about their most important wish, the answer is not a house, a new refrigerator or even health services, but rather access to a job, helping to unlock their independence and economic liberty.

SME finance complements micro-credits as a true employment and entrepreneurship tool, helping businesses launch and grow, and thereby creating important multiplying effects in local economies. It offers an important contribution towards financial inclusion and in addressing the phenomenon commonly referred to as the *missing middle*. SMEs make up in excess of 95% of all registered companies, around 2/3 of the total workforce and typically around half of GDP. As illustrated in the graph on p26, this is not the case in low and middle income countries which lack the access to capital necessary to provide the financing infrastructure needed to develop a vibrant SME sector.

8 World Bank Enterprise Surveys: World Bank List of Economies



Micro, SMEs and Large Firms in High and Low-income Countries: The SME sector, backbone of advanced economies, is often missing in developing countries

(Source: Harvard University)

According to the International Finance Corporation (IFC), the financing gap of SMEs in developing countries is estimated at between USD 2.1 and 2.6 trillion, with in total between 200 and 245 million unserved or underserved small businesses[9]. Markets where the SME-sector is largely missing are typically characterized on one hand by a majority of the population being self-employed or vulnerable working poor, earning less than USD 2 per day with little access to financial services and security, and on the other hand by state-owned enterprises and foreign multinational corporations which concentrate wealth and value creation in the upper segments of the population. The economic fabric in between is largely missing, whereas in developed economies it is today the main source of economic resilience and has historically been the main driver in promoting innovation, employment and capital accumulation, ultimately building a middle class and reducing income inequality.

The challenge consisting in developing an SME sector in developing economies is immense and complex. It is not only about creating new jobs for fast growing populations, but also about creating decent ones, paying a salary above USD 2 a day. According to the International Labour Organization (ILO), only half of the 3 billion people employed globally today earn a regular salary, and thus have a sense of security in their income stream. In Africa alone, two thirds of the currently employed are working poor[10].

9 IFC 'Closing the Credit Gap for Formal and Informal MSMEs', 2013
10 Brookings Institute 'Sub-Saharan Africa's Twin Jobs Challenge' 2014

The problem of jobless growth and high youth unemployment is a fundamental challenge for these markets. The solution lies precisely in the development of the SME sector. Building financially inclusive services and injecting capital into small business opportunities is a proven tool towards economic development, autonomy and prosperity. Filling the missing middle in emerging and frontier markets is thus a crucial step. By contributing to the emergence of these local virtuous cycles in the emerging world, microfinance investors stand again to make an exemplary combination of a financial and social return in their portfolios.

3d ACHIEVING THE 2030 SUSTAINABLE DEVELOPMENT GOALS

Investors are becoming increasingly conscious of the role their investment portfolios can play, not only as a source of financial income for oneself, but also as a powerful source of impact on environmental and social dynamics. Both institutional and private investors are also increasingly signing up to various types of initiatives around sustainable finance, whether simply through association or through binding principles.

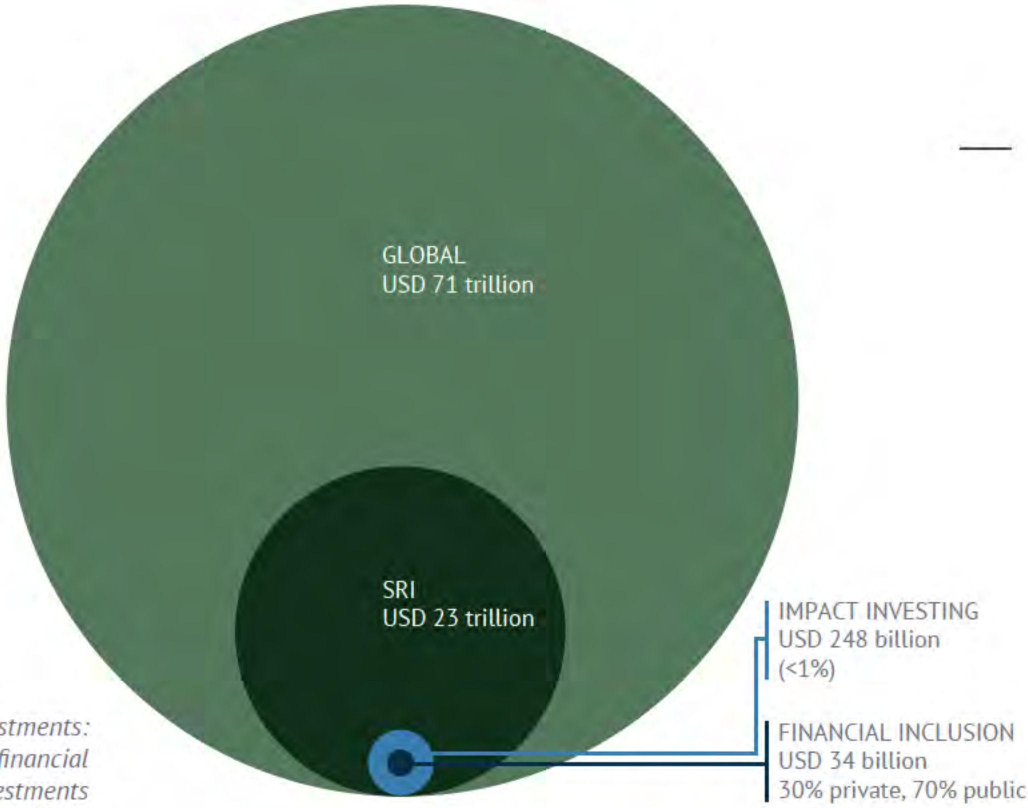
The overarching norms of the sustainable finance industry were initially defined by the United Nations Agenda 21, in the 1992 Earth Summit and Rio conference. They were later refined through the Millennium Development Goals of 2015, and most recently through the Sustainable Development Goals (SDGs) of 2030.

The 17 Sustainable Development Goals and Their 169 Targets for 2030: 'This Agenda is a plan of action for people, planet and prosperity. We are resolved to free the human race from the tyranny of poverty and want and to heal and secure our planet. We are determined to take the bold and transformative steps which are urgently needed to shift the world onto a sustainable and resilient path.'

(Source: United Nations Sustainable Development Knowledge Platform)

Investors adopting the sustainability principles understand the paradigm shift in which they find themselves and have bought into the changing investment perspective this entails. They are actively seeking products and services which contribute to achieving the goals. As a development still in its early phase, it is fair to say that so far, demand for such investment solutions far exceeds the supply. Today, about a third of global capital is allocated to socially responsible strategies, with only a small fraction directly into impact investment strategies focused on private investments into the real economies of emerging and frontier markets. Even if still nascent, this trend in impact investing is meant to grow rapidly, with hundreds of funds and investment service firms developing in recent years. Among others, the Global Impact Investing Network (GIIN) aims at recognizing the unique role that impact investing will play in achieving these goals and building a sustainable future[11].

11 GIIN 'Achieving the Sustainable Development Goals: The Role of Impact Investing' 2016



Sustainable Investments: Although growing quickly, financial inclusion and impact investments remain a small part of the global investment universe

(Source: Global Sustainable Investment Review 2016, CGAP, and Boston Consulting Group)

Today, microfinance is probably the most prominent investment solution for achieving the sustainable development goals, something also confirmed by the World Bank's Consultative Group to Assist the Poor (CGAP), which sees microfinance, through the promotion of greater access to financial services, as a key enabler of many of the SDGs. The first – ending extreme poverty – explicitly mentions the importance of access to financial services. But for CGAP microfinance also contributes to improving food security (SDG2), health (SDG3), education (SDG4), gender equality (SDG5), water and sanitation (SDG6) or energy (SDG7), through investments and services targeted at these topics. They similarly include access to credit and innovative financial services, such as digital and mobile banking, contributing to shared economic growth (SDG8), sustainable industrialization (SDG9) and ultimately positively affecting goals of equitable and peaceful societies (SDG 10 and 16)[12].

For financial investors paying little attention to the development impact of their capital, the SDGs may seem like government policy-making agendas. But for investors who understand the paradigm shift in global economics, it becomes obvious that private retirement portfolios in the North and global development in the South are interconnected and mutually dependent to function properly.

12 CGAP 'Achieving the Sustainable Development Goals' 2016

4
KEY TAKEAWAYS

Microfinance investments are neither a holy grail, nor a panacea. Most importantly, by definition they do not produce anything themselves, but rather put capital at the disposal of others. They thus largely depend on the microfinance institutions they partner with for upholding principles of social responsibility, financial savviness and purposeful implementation, as it is these that channel the capital further towards micro-entrepreneurs. Institutions in turn depend on end clients and their capacity to manage opportunities and risks, and thereby plan their path out of poverty towards a more sustainable and prosperous lifestyle. Keeping this in mind, microfinance investors do however have the merit of contributing to the paradigm shift of the 21st Century by providing a channel for capital to be invested in markets out of the mainstream, with high capital demand and value creation potential. Most importantly, whilst doing so they are also acting in their self-interest, diversifying and stabilizing their portfolios and giving a long term perspective and depth to their savings plans.

Investors in microfinance, by being conscious of their investment decisions, hereby send several clear signals to markets:

- They understand that developed nations have ageing and shrinking populations, a long-term trend that undermines economic growth prospects and economic development for the purpose of capital preservation and accumulation.
- They understand that as a consequence, the expansion of developed financial markets has its limits and that it is not by kicking the can further down the road that problems will disappear. The most probable, realistic scenario today is that developed markets continue to see low or even negative growth, in combination with low interest rates and low inflation figures.
- They understand that the combination of low growth in the developed world and a demographic explosion in the emerging world cannot be solved by quick fixes or short-term populist policies. Such game-changing macro-economic factors necessitate far more ambitious policies of co-development, channeling excess domestic savings to economies with fundamentally different demographic and economic growth dynamics, and with a large and unmet demand for financial services to further sustain their socio-economic development.

- They understand the enormous potential inherent in direct investments into emerging and frontier markets, and the role such investments can play in improving both the absolute and the risk-adjusted performance on investors' capital savings or retirement plans.
- They help break down stereotypes and mental barriers on underdeveloped countries and help the understanding that it is of global interest to assist emerging economies in reinforcing their regulatory environments, legal frameworks and financial policies, and that the best way to do so is through investments.
- They support the adoption of sustainable investing practices and the understanding that it is in all our interest to promote long-term, sound economic development on a global scale.

Microfinance investments are certainly not the solution to all problems, and much larger efforts will be required to resolve global imbalances. Since more than a decade, microfinance funds have however provided investors with an investment solution combining very low volatility with low- to no correlation to other asset classes, and thereby with an investment that acts as a portfolio stabilizer during market distress. Doing so while contributing to a more sustainable and inclusive world, they have truly allowed microfinance investors to confirm the narrative of doing well by doing good. Most importantly, they position private and institutional investors as stoic weavers of a global sustainable development. They serve as a growing illustration of both resilient and creative financial investors who are conscious of, and accountable for, the consequences of their choices. At the minimum, they will avoid their own children and grand-children one day wondering how investors and portfolio managers in developed countries could continue for decades to invest predominantly into their saturated, declining and over-indebted home markets, rather than to support and profit from the massive opportunity that was for all to see in the emerging part of the world.

SWITZERLAND
Symbiotics SA
Rue de la Synagogue 31
1204 Geneva
t +41 22 338 15 40

SWITZERLAND
Symbiotics SA
Forchstrasse 280
8008 Zurich
t +41 43 499 87 89

MEXICO
Symbiotics Mexico S de RL de CV
Diagonal Patriotismo 12 - 602
Colonia Hipódromo
06100 México D. F.
t +52 55 55 84 78 72

SINGAPORE
Symbiotics (Singapore) Pte. Ltd.
134 Amoy Street
#03-01
049963 Singapore
t +65 31 63 71 80

SOUTH AFRICA
Symbiotics I, C & S South Africa Ltd.
4 Loop Street, Studio 502
8001 Cape Town
t +27 21 425 51 19

UNITED KINGDOM
Symbiotics UK Ltd
6 Bevis Marks
London EC3A 7BA
t +44 203 786 1186

symbioticsgroup.com