



Enterprising Solutions Brief No. 3

The Potential For Social Investment in Microfinance and Small Enterprise in Developing Countries

Enterprising Solutions Global Consulting

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Enterprising Solutions Briefs

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The Potential for Social Investment in Microfinance and Small Enterprise in Developing Countries

Introduction

Socially-oriented investors in the US, Canada, Australia and Europe have long been interested in social investing in developing countries, but have seldom had viable vehicles through which to make such investment. Still fewer options have existed for investing in microfinance institutions (MFIs). There are several reasons for this, the most important being that social investment itself is a relatively young sub-sector of the financial industry and has mostly focused on domestic, large capital stock corporations.¹ Although a relatively new phenomenon, socially responsible investment (SRI) has grown to significant size (see Table 1). SRI also continues to grow despite three years of declines in equity markets worldwide, with inflows of new money to retail SRI mutual funds totaling over \$1.5 billion in 2002, in contrast to the outflow of over \$10 billion from conventional funds that same year. However, the SRI growth was largely been limited to the markets of developed countries. Only very recently have emerging markets become a topic of focus among social investment practitioners.

Political and economic conditions in the developing world have always held special importance for the social investment community. There is perhaps no greater singular source of inspiration in SRI history than its role in the dismantling of South African apartheid through the divestment movement. More recently as well, there have been other important

involvements by the SRI community in issues affecting developing countries, including focus on human rights in Nigeria and Burma (Myanmar), on workers' rights in the Mexican *maquiladora* regions and on child and sweatshop labor in Asia and Latin American.

Interest in these issues unfortunately has yet to translate into much in the way of significant SRI flows to developing countries. Of the total \$600 billion invested in SRI mutual funds, only an estimated \$52 million went to large-capital stock market assets in emerging markets (figures are for the U.S., Canada, Britain and Australia only - see Table Two). Another estimated \$200 to \$250 million went to funds invested in MFIs and in small- to medium-sized enterprises (SMEs). Of these, only two or three funds have been made broadly available to social investors, and with few exceptions, funds request below-market rates of return from investors. Returns to commercially-oriented developing country SRI mutual funds have also been poor, but have picked up over the last year, registering a return of -13.4%, compared with the Standard and Poor Index of -20.5% (as of September, 2002).

Table 1 Worldwide Social Investment			
	SRI Investment (Figures in \$US billions)		SRI as % Market Capital Total
	Assets		
	1999	2002	
United States	1490	2030	12%
United Kingdom	82	354	na
Canada	32	30	3.2%
Europe	na	17.6	1.0%
Australia	6.3	8.3	<5.0%
Total	1760	2439.9	--

SRI in Emerging Markets

The modest amount of social investment in emerging markets belies a high degree of interest in MFI investment opportunities (see Table 2). A recent poll of social investment professionals conducted by Enterprising Solutions suggests significant latent demand among both individual and institutional social investors for high impact social investments in microfinance institutions and small and medium sized businesses.

The Enterprising Solutions poll took place during September 2001 and the late winter/ early spring of 2002.ⁱⁱ Of the 72 professionals contacted, a total of 34 were polled, for a 47% response rate. The poll represents approximately 6% of the estimated 600 SRI professionals (self-identified) in the United States.ⁱⁱⁱ Thus, though not statistically representative, findings can indicate the existence of trends *visa vis* high impact, SRI emerging market investment interest.^{iv} Of the SRI professionals polled, 50% were institutional investment professionals, 27% were financial planners, and 21% were brokers (see Tables

3 and 4). The total funds directly and actively managed by the interviewees is \$8 billion; their companies manage \$71 billion, representing approximately 0.38% and 3.38% respectively of the \$2.1 trillion SRI funds reported by the Social Investment Forum (SIF) in April 2001.^v The SIF also estimates that of the \$2.1 trillion in social investments, approximately \$600 billion is actively managed with social and/or environmental screens. Thus, poll interviewees directly control approximately 1.35% of all SRI assets and their companies, control the equivalent of 11.8%.

Given the appropriate investment vehicle, 12 of the 27 SRI professionals interviewed indicated the ability to place between \$100,000 and \$500,000 in emerging market high impact investments. Another, four believed that they could invest between \$500,000 and \$1 million. Three professionals indicate that they could invest more than \$1 million and \$5 million, and four believed they could place over \$5 million each. The remaining professionals surveyed did not respond to this question.

Table 2
Developing Country Social Investment Mutual Funds
(holding publicly listed investments only)

	Country of Origin				Total
	USA	Canada	United Kingdom	Australia	
Fund Asset Values (figures in \$US millions)					
SRI Funds with Emerging Market Holdings	2	6	7	1	16
Total Emerging Market Assets of SRI Funds	20	15	16	.6	51.6
Total Emerging Market Assets (% of SRI Funds)	.01	.27	.02	0.0	-
Fund Performance (net asset value)					
SRI - 5 Year Returns (%)	-23.1%	-6.7%	-6.7%	0.0%	
S&P 500 Index 5 Year ¹	-1.6%	-1.6%	-1.6%	-1.6%	
SRI - 3 Year Returns (%)	-39.2%	-7.14%	-34.6%	11.8%	
S&P 500 Index 3 Year ¹	-12.9%	-12.9%	-12.9%	-12.9%	
SRI - 1 Year Return (%)	-13.4%	-9.6%	-22.1%	-4.5%	
S&P 500 Index 1 Year ¹	-20.5%	-20.5%	-20.5%	-20.5%	

¹ Results as of October 1, 2002 ² Results as of December 31, 2002

Most financial planners and brokers noted that their high impact demand estimates were arrived at from the combined interest of many modest net-worth investors (with portfolios of less than \$500K) who would consider placing between 1% and 5% of their assets in high-impact emerging market investments. Professionals managing \$5 million or more represent high-net worth individuals (\$1 million or more in assets) and institutional investors.

Extrapolating from the poll findings on Table Three, Table Four shows that SRI demand for emerging market high impact investment demand is significant at US\$4.7 billion or 0.8% of all actively managed funds.^{vi} Follow up consultations with a range of SRI professionals predicted

a demand of between 0.5% and 1%, representing \$3 billion and \$6 billion respectively. We arbitrarily and conservatively use \$5 billion as an order of magnitude expression of demand.

If there is Demand...?

Given the order of magnitude of potential demand, *why are so few funds invested in emerging market high impact investment?* Based on our research of SRI vehicles and MFI-FIs we believe that

a lack of adequate financial intermediation is the simple answer. Holding this aside for the moment, SRI professionals see a range of interrelated issues combining to make emerging market high-impact investments difficult to make.

**Table 3
SRI Professional Poll Overview**

	Number Polled	%	Managed by Interviewee (figures in \$US billions)	Managed by Inter-viewee Company (figures in \$US billions)
Institutional Investment Professional	17	50.0	\$7.7	\$68.0
Financial Planner	9	26.5	\$0.22	\$1.2
Broker	7	20.6	\$0.18	\$2.2
Other	1	2.9	na	\$70.0
Total	34	100.0	\$8.1	\$71.3

* Unweighted total expected return average

Table 5 reports that the greatest concern among SRI professionals is the lack of comprehensive information on emerging market countries. This is followed closely by the need to have strong emerging market and high impact investment fund management capacity, and the need to have social and environmental impact measures that can be benchmarked against other investments. Oddly, risk and return is the second-least noted

**Table 4
SRI Professional Estimated Small Businesses & MFI Emerging Market Investment**

Estimated Investment Amount	All	Institutional	Financial Planners	Brokers
\$100K to \$500K	12	2	7	4
\$5K to \$1M	4	0	2	2
\$1M to \$5M	3	3	0	0
More than \$5M	4	4	0	0
Total Investment Available among Polled	\$56.5 million	--	--	--
Total Estimated Investment Available in SRI Industry (As a percentage of directly controlled funds)	\$4.70 billion	--	--	--

Nine respondents did not answer this question.

concern, followed by the availability of a regulated investment vehicle.

Concerns vary significantly by investor type (see Table 6). Financial planners are relatively fearless yet practical, viewing the availability of an regulated investment vehicle as the main barrier to investment. Institutional investors, by contrast, rate appropriate vehicles as less of a challenge, with concern about country intelligence, managing investments, and measuring social impacts being slightly less but almost equal.

Brokers see social impact as the most challenging issue and have more moderated concerns about the remaining variables.

expect less at 12% and brokers more at 16%, with institutional investors in the middle at 14%.

Without access to an accepted asset benchmark, however, performance expectations are difficult to understand relative to competing investments. Five-year performance figures (September 1998 to September 2002) for US-based emerging markets equity mutual funds, for example, have returned -23% on average, while the Standard and Poor's 500 index returned -1.6% over the same period. By comparison, an Enterprising Solutions survey of specialty funds investing in microfinance institutions reported a range of returns from as low as 3% to as high as 14%. MicroRate, a microfinance rating agency, recently reported 10 of the top performing Latin American microfinance institutions had ROEs of over 20% for the last year.^{viii}

Interestingly, SRI professionals responding to the poll are not without emerging market investments; almost half have made some kind of emerging market investment. Moreover, many investors have experience with a range of other emerging market investments, though primarily mutual funds and some private equity deals. Another 50% have experience with large capital stock market investments. Finally, some 15% have some form of small business investment experience in emerging markets.

The Right Vehicle ?

Table 6 reports SRI professional preference for five different forms of financial intermediation for emerging markets high impact investments.^{vii} Mutual funds are the clear favorite among all investor types. A specialized fund management company was the second most preferred option with direct equity and debt, and venture capital funds being the least favored.

The combined (un-weighted) average annual rate of return expected is 14%. Financial planners

**Table 5
Barriers to SE and MFI Investment in Emerging Markets**

	All	Institutional	Financial Planners	Brokers
Country Intelligence	3.0	3.1	0.5	2.8
Managing Emerging Market Investments	2.8	3.5	2.0	3.0
Social Impact Measurement	2.7	3.3	2.0	4.0
Risk and Return	2.3	2.2	1.9	2.6
Appropriate Vehicle	2.0	1.8	2.0	2.5
Interviewees were asked to rate each of the above barriers to making investments on a scale of 1 to 5, with 5 providing the greatest barrier and one the least option. Results were combined to produce and average rating score.				

**Table 6
Investment Vehicle Preferences**

	Institutional Investors	Financial Planners	Brokers
Mutual Fund	3.9	3.3	4.2
Specialized Fund Management Company	2.9	2.5	2.7
Direct Debt	2.2	2.3	2.5
Venture Capital fund	1.6	2.2	2.3
Direct Equity	1.8	1.8	2.0
Interviewees were asked to rate each of the above investment vehicles on a scale of 1 to 5, with 5 being the most attractive and one the least attractive option. Results were combined to produce and average rating score.			

Summary

Historically, socially responsible investing has had significant ties to emerging market issues; nevertheless there has been relatively little intermediation of capital from developed to emerging market countries. This stands in contrast to the predisposition among socially responsible investors to making high impact investment in emerging market SME and MFIs.

Fortunately, social investment professionals have a fairly clear idea of the requirements to making emerging market investments on a larger scale. Most of their concerns, such as the need for greater country information or emerging market management capacity, can be overcome in part with proper technical expertise.

Even SRI return expectations not out of reach of the potential return of good MFI-FIs, particularly if proper risk assessments are made. Unfortunately, and casting aside the optimistic SRI demand estimate of almost \$5 billion from the recent Enterprising Solutions survey of SRI professionals, even our more conservative estimate of \$3 billion outstrips the capacity of existing MFI-FIs by a factor of five. This is compounded by a lack of strong demonstrable interest among MFI-FIs to source SRI capital. Our

investigations also show that the few serious efforts made by MFI-FIs to cultivate social investment interest have not met expectations primarily because of challenges of achieving scales sufficient to cover start-up and development costs and regulatory barriers (e.g., daily valuation of funds, registration requirements etc.).

This observation is all the more relevant when we consider that social investment professionals prefer a mutual fund as the ideal fund investment vehicle: a model that conventional wisdom suggests requires some \$50 million or more to reach sustainability. Moreover, we must ask whether any one fund can wield the variety of investment vehicles, particularly growth capital, required to finance MFIs. The unlikelihood of this suggests the need for greater investment in MFI-FIs.

Notes

ⁱ Social investment is best known for its growing number of socially screened mutual funds. These funds differ from conventional funds only in that they *screen* investments according to criteria related to social and environmental issues. The majority of funds apply negative screens, excluding companies considered to be the worst offenders on a given issue. Thus, as long as mining companies X and Y have better overall environmental records than all others in the mining sector, they may be included in an SRI mutual portfolio despite having less-than-perfect environmental practices. In contrast, positively-screened funds seek to invest in companies that pass strong social and or environmental standards. Positive-screening funds have higher social-return expectations and often tend to focus on one or two issues such as the environment or low-income housing. For more information on social investment, please see the Social Investment Forum web pages at www.sif.org.

ⁱⁱ The original SRI professionals polling methodology was to conduct personal interviews at the 2001 annual US national conference for SRI professionals, held September 10-13, 2001. Due to the events of September 11, however, the poll was postponed until the spring of 2002 when it was delivered via email and by telephone.

ⁱⁱⁱ Reported at the SRI in the Rockies Conference, October 17-20, 2002.

^{iv} For the purpose of this poll, emerging markets includes all developing country markets as defined by the International Finance Corporation see www.ifc.org.

^v Actively managed funds referred to funds which buy and sell investments on an ongoing basis. The balance of funds are those which have active shareholdings on given social investment issues. Polling results are unadjusted.

^{vi} Readers need to recall that the poll is not statistically significant, and thus findings can only be considered indicative of demand. Estimates are based on investment levels estimated by number of professionals and by volume category. For each category we supposed that an average investment would equal the midway point of each category (i.e., \$750K for \$500K and \$1M). This was multiplied by the number of professionals in the category yielding a total estimated investment. This was done for each category. For \$5M plus, we conservatively used \$5M as the estimate understanding that the number could be much larger. The sums for each category were summed and then divided by the appropriate numerator to obtain estimates.

^{vii} Interviewees were asked to rate each of the options on a scale of one to five, with five being the most attractive and one the least attractive option.

^{viii} (see The Finance of Microfinance, October 2002, published by MicroRate 2002 by contacting info@microrate.com).