# Behavioral biases and private investments in microfinance

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# Executive Summary

The positive evolution of the inclusive sector's reputation and effectiveness has attracted in recent years many private investments worldwide, also from high net worth individuals (HNWIs) seeking reasonable risk-adjusted returns with an ethical orientation. Microfinance (MF) is listed among the socially responsible (SR) investments, which have experienced a substantial growth in the last years as a whole. Either in the form of equity capital or debt, there are nowadays many ways through which money can be channeled from the individual to reach the investible microfinance institutions (MFIs).

In order to do this, investors usually apply to microfinance investment intermediaries (MIIs), mostly belonging to the category of microfinance investment vehicles (MIVs). Those intermediaries offer, in general, specialized investment products to interested investors (institutions or individuals) and are in charge of organizing the investment flow toward the selected MFIs. The work of the MIIs is also to report on the social impact aimed by the product sold.

Possible but much rarer is the event of a MFI opening up to international capital markets, e.g. by conducting an initial public offering, a bond issue or a loan securitization.

There are still evident limits to the private investments in MF by HNWIs, e.g. the small number of MFIs ready to absorb such investments. However, signals are very positive so far. The decision to allocate some capital in a MF related product can be very promising for both investor and investee. However, as with most other financial decisions it is subject to a degree of uncertainty, concerning payoffs and event probabilities. Thus, an investment choice can potentially (and unconsciously) be biased.

Behavioral biases are generally understood as psychological traps, which „apply to me, you, and everyone else as well" (Montier 2007, 18). In other words, they are the result of the individual use of heuristics, or "rules of thumb” to simplify a decision’s framework. It has been demonstrated that individuals act under bounded rationality, and sometimes make irrational decisions (in particular when an event’s probability is not estimated in a rational way, i.e. by Bayesian updating).

## Objective

Neuroeconomic research has provided so far very intriguing results on the way our brain elaborates information in the decision-making process. The aim of this study is to apply the knowledge from behavioral biases studies to a specific investment decision by QIIs. We undertake a conjoint analysis of private investments in MF and of behavioral biases with the objective of formulating hypotheses on which biases could apply to those investors when deciding to allocate money in a MF related product.

## Method

First we present the actual stand of private investments in microfinance, with particular focus on the different kinds of MIIs and their offer. Second, we review the basic elements of decision theory, with two complementary studies on the particular features of a SR investor’s utility and portfolio optimization. These elements will then help us to understand how the behavioral biases work, and the reasons why some of them might or might not apply to the QIIs of interest. To conclude, we sketch a possible experiment to test three of the formulated hypotheses.

## Results

Overall, private investments in MF operated by QIIs might be biased in more than one dimension of the decision-making process.

As first element of the process, the selection of information for the choice is likely to be distorted by the *availability bias*. Consequently, this may also cause an *overreaction* toward new information.

The information elaboration is a delicate step before the final decision, thus individuals have frequent recourse to heuristics. According to our analysis, QIIs' information elaboration might be affected by the *representativeness bias*, *anchoring*, *conservatism*, the *framing bias*, *overconfidence*, and by the *illusion of control*.

After the information has been selected and evaluated, the individual is ready to make the final decision. Again, decision-makers are likely to make use of "rules of thumb" in their effective choices. In our opinion, *mental accounting* and *house money effect* are candidate biases. Moreover, we expect the existence of some *disposition effect*, *endowment bias*, as well as *sunk costs bias*. However, these deviations can also be explained by the SR orientation of investors, which gain additional utility from an investment's ethical label and optimize portfolios differently from conventional investors.

The last component of the decision-making process is the feedback investors receive. Depending on its evaluation, individuals can modify, and in the best case improve, the process leading to the next choice. Both *hindsight bias* and *psychological call option* are potential disturbing elements for a correct decision's evaluation about a private investment in MF.

An additional dimension that a choice is subject to is intertemporal discounting, which means evaluating today future payoffs. In our view, the QIIs of interest are as likely to be affected by an intertemporal decision bias as are conventional QIIs, i.e. they both discount future events in a non-consistent way. The bias might, however, play a positive role by encouraging investments in MF.