Microfinance Investments:
A Source of Alternative Return in Modern Asset Allocation?

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Abstract

Although the microfinance industry is growing rapidly, there are still a large number of people living in developing and emerging countries who lack access to basic financial services. In times of depressed interest rates on fixed income markets and uncertainty in stock markets, investors are increasingly looking towards alternative investments to diversify their investment strategy and enhance portfolio yields. This thesis investigates whether microfinance investments can become an integral component of modern asset allocation strategies alongside other alternative investments. Firstly, returns for microfinance investment vehicles are regressed on global benchmark indices in order to identify correlations to other asset categories. Secondly, based on the mean variance concept, a set of microfinance investment vehicles is built in optimal asset allocations to test whether microfinance is able to increase portfolio efficiency. The regression illustrates the high resilience of microfinance investment vehicles to global market indices of all analysed asset categories. Furthermore, the microfinance investment vehicles improve optimal asset allocations in terms of risk reduction for a given level of return for portfolios with small to medium mean returns. Moreover, the integration of microfinance as a new asset category substantially enhances the sharpe ratio of the capital market line. Backtesting the optimal asset allocations with and without microfinance shows that especially portfolios with mean returns of 1% to 3% p.a. benefit from the diversification that microfinance brings. Additionally, the tail end risk of portfolios can be reduced for portfolios with small to medium returns of up to 7% p.a., which is confirmed by the Value at Risk measure. In conclusion, the allocation of microfinance investments to a small to medium returns portfolio increases efficiency and allows for increased diversification.