7 Conclusion

7.1 Summary of results

Microfinance is an interesting asset class with a double bottom line. Social as well as financial returns can be generated and therefore fit in today's time as many institutional and private investors seek for sustainable investments. Up to now, a single digit billion market size indicates that the market is not mature. However, firstly it is growing tremendously. Secondly, for strategic asset allocation purposes also small asset categories can be considered and emerge with investors' money. A perfect example for this is the cat bond market with about USD 16 billion currently outstanding.

A major difficulty is the inexperience of investors and the short investment history of microfinance. Microfinance debt investment vehicles broadly diversify across countries and microfinance institutions. However, the underlying risk is a credit portfolio of small enterprise loans in emerging markets. The assessment of return and risk parameters proves to be difficult, standard credit screening processes of rating agencies such as Fitch or Standard & Poor's are not convincing yet. Furthermore, the risks and mission of microfinance credits may shift with the evolution of the asset class. Thus, also new risks may affect investments.

The results of the quantitative approach in this study demonstrate the potential of microfinance in a strategic asset allocation framework, but the validity of results is questionable. Despite a high illiquidity discount, microfinance debt investments dominate the optimized model portfolios with up to 45%. As discussed, the derivation of risk and return parameters is problematic, because past evidence is scarce and does not include many economic regimes or innovation potential. This is a typical problem set of a young, emerging asset class.

The theoretical concept outlined in this study to address such a problem set is scenario planning, which is practically proven in various fields. A structured scenario process with expertise of all involved fields generates relevant information and development perspectives of a new asset class. Hence, a qualitative approach such as scenario analysis extends the capabilities of a quantitative asset allocation context.

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The conducted scenario analysis on microfinance demonstrates chances and risks of the two asset classes: microfinance debt and microfinance equity. The process was led by scenario experts from Daimler AG and the participants included well-known specialists from microfinance as well as emerging market and asset allocation senior professionals from LGT CM. The scenario analysis was realised in various pre-meetings, two two-day off-sites with all participants and a closing day. During the process the team developed several scenarios for microfinance and assessed the impact on microfinance debt and equity investments. As a result, the qualitative process reveals a difference in the return profile of microfinance debt investments compared to a common quantitative analysis. Moreover a return estimate for microfinance equity investments is generated. In addition, the scenario analysis determines a higher correlation and risk of microfinance investments than currently expected by most market participants and quantitative analysis. As a consequence, the process unveils a different picture of microfinance investments than a common quantitative analysis of past performances would demonstrate.

The integration of the results of the microfinance scenario analysis into an asset allocation framework reveals only a very slight attractiveness of microfinance debt investments. It discloses the overestimation of this asset class by a common quantitative assessment. According to performed portfolio optimizations with qualitatively derived input parameters, microfinance debt investments are slightly attractive for risk-averse investors. An addition of about 2-5% microfinance debt exposure is suggested. For institutional and return seeking investors the volume of the asset class and the return potential limit the attractiveness. However, local currency microfinance debt and microfinance equity investments offer a higher return potential. But up to now investment possibilities in these specific asset categories are very limited. These results are reasonable from a practitioner's point of view, but they stand in contrast to portfolio optimizations with quantitatively derived input parameters that recommend a microfinance debt exposure of up to 45%. In conclusion, microfinance debt investments improve the return/risk pattern of an investment portfolio and shift the efficient frontier slightly to the left.

7.2 Outlook and implications

Asset allocation and scenario methodologies intertwine perfectly. In the specific case of a new asset class this study demonstrates that the qualitative approach of a scenario process captures more relevant information also regarding asset allocation as opposed to a common quantitative approach. Furthermore, the forward-looking character of this approach generates asset allocation input parameters in the required forward-looking dimension. In contrast to this, quantitative models cannot overcome the problem of extrapolating estimates from past data. This allows by definition no innovation or mission drift and assumes that all relevant scenario information is included in the past data series. As a result, a well-structured qualitative approach to generate asset allocation input parameter dominates quantitative approaches.

A qualitative methodology is a key instrument for the integration of young asset classes into an asset allocation context. Firstly, the process develops a deeper understanding of the asset class and takes several perspectives for an assessment into consideration. Secondly, a comprehensive set of asset allocation input parameters can be derived with a forward-looking perspective. The innovative character, a possible mission drift and several potential futures are analysed and allow a profound evaluation. In conclusion, a qualitative approach such as scenario methodologies is a rational way to assess emerging asset classes. The problematic quantitative evaluations of newly structured products as seen in the last decade are an indication for this.

Scenario analysis is a comprehensive tool to close the gaps of the quantitative assessments for asset allocation purposes and generate an added value. However, a scenario process also has to cope with the limitations of a team process such as motivation or political issues. Furthermore a scenario analysis is a time-consuming and hence costly approach. But for the same reasons, the decisions that are made have the common basis of all participants and are a reasoned assessment. In conclusion, a scenario process is an adequate assessment tool both for new asset classes and also for mature ones.

This study shows that quantitatively driven asset allocation can be problematic. A qualitative assessment of asset classes with scenario methodologies is an adequate supplement to quantitative approaches in asset allocation. It enhances the quality of as well as the trust in asset allocation parameters. However, performing scenario approaches for all asset classes is very time-consuming and costly. Thus, a focus on selected asset classes is advisable. The criteria to select asset classes for an additional qualitative analysis with scenario methodologies are innovation or mission drift, illiquidity and desired knowledge transfer for participants. As discussed, a new pattern of an asset class cannot be captured in quantitative analysis. The increase of government debt in many countries following the credit crises might be such a turning point in the government bond market. Illiquid asset classes cannot be traded at any time. Furthermore some investments such as private equity or forest investments are taken for 7-20 years and the secondary market is small. Consequently, illiquid asset classes such as private equity, hedge funds and the small but very attractive asset class cat bonds qualify for a scenario analysis. Additionally, investors' know-how regarding these asset classes is often limited and can be increased throughout the scenario process. As a result, a scenario approach is recommended for hedge fund and private equity investments due to the asset class characteristics. Moreover, the current economic environment advises an analysis of the government bond market.

In conclusion, an adequate consideration of the magic triangle of asset allocation – namely return, risk and liquidity estimates – can be applied with an intertwined approach of qualitative and quantitative assessment methodologies.