Food for Thought | Vol. 1 Issue 1 | May 2024

Impact Investing in Developing Markets: Addressing the Misperception of Risk

Impact investing has emerged as a powerful tool for addressing social and environmental challenges while generating financial returns. However, a significant barrier hinders the flow of capital into developing markets: the misperception of risk.

Investors often perceive developing markets as excessively risky, a sentiment that was critically examined during the recent SDG Impact Finance Initiative (SIFI) event in London in April 2024. Financial experts highlighted that the perceived risks in these markets frequently overshadow the actual risks. For instance, data presented at the event showed that the default rate for Development Finance Institution (DFI) transactions rated as CCC+ is less than 5%, thanks to adept financial structuring. Despite these low default rates, the prevalent investor mindset remains skewed towards an exaggerated sense of risk.

This misalignment is further compounded by rating methodologies that do not adequately reflect the unique dynamics of impact investments. There is an urgent need for revised methodologies that incorporate the nuances of blended finance transactions, leveraging the sufficient dataset of blended finance transactions by other organisations. Moreover, sovereign risk ratings often unfairly influence the ratings of impact companies, overshadowing their true stability and potential. To shift investor perceptions, it is crucial to enhance transparency and data granularity at the sector and country levels.

Supporting this argument, the GEMs database consortium's report on recovery statistics provides compelling evidence. Presenting statistics on DFIs' private and sub-sovereign operations from 1992 to 2022, it is the first time that the wider public gains insights into the performance of development finance investments. The report reveals that recovery rates in low-income countries are often higher than those in high-income countries. Specifically, the average recovery rate for contracts of private counterparts in sub-Saharan Africa is 83%, compared to significantly lower rates in more developed markets. While recognising the DFIs enjoy a preferred creditor status with repayment priority, these statistics challenge conventional wisdom and highlight the resilience and potential of investments in developing markets.

Additionally, the Tameo PAIF Report 2023 indicates that private asset impact funds have shown resilience during market downturns, further challenging the misperception of risk. The report states that despite global market volatility, impact funds have maintained stable performance, demonstrating their potential for reliable returns even in challenging economic environments. >>

Adding an academic perspective, a study by Jeffers, Lyu, and Posenau (2022) sheds light on the financial performance of impact investing funds. The study found that while impact funds have a lower market beta compared to traditional venture capital funds by $0.45 per $1 invested, they do not necessarily underperform when adjusted for market risk. This finding underscores the potential for impact investments to provide competitive returns while addressing critical social and environmental issues.

Addressing the misperception of risk is vital for scaling up impact investing in developing markets. By realigning investor perceptions with actual data, improving transparency, and developing innovative financial structures, stakeholders can unlock the full potential of impact investing. Collaborative efforts between financial institutions, rating agencies, and governments are crucial in creating a thriving ecosystem for impact investments.

Food for Thought:

- How can investors be persuaded to trust data over their preconceptions when it comes to developing markets?
- What steps can rating agencies take to better reflect the actual risk profiles of impact investments in developing markets?
- How can greater transparency and data granularity be achieved in impact investing?

The SDG Impact Finance Initiative invites you to engage with us and the broader community on our LinkedIn page!

References:

- Agrawal, Ajai. 2021. *Impact Investing: Review and Research Agenda.*
- GEMS Database Consortium. 2022. *Recovery Statistics Private and Sub-Sovereign Lending 1994-2022.*
- Jeffers, Jessica, Tianshu Lyu, and Kelly Posenau. 2022. *The Risk and Return of Impact Investing Funds.*
- Tameo. 2023. *Private Asset Impact Fund Report 2023.*
- SDG Impact Finance Initiative. 2024. *Event Summary: Addressing the Misperception of Risk and Lack of Liquidity in Impact Investing.*
- Luitel, Prabin. 2016. *Pernicious Effects: How the Credit Rating Agencies Disadvantage Emerging Markets.*