

Benefits of international diversification

Focus on the UK LBO market

Empirical evidence shows that limited partners exhibit home bias when selecting PE fund managers¹. This behaviour is reflected in selecting both fund managers domiciled in the same region and in preferences for investments located in limited partners' geographical proximity. From the geographical exposure perspective, investors are facing a trade-off. Investing close to home brings informational advantages as well as better access to fund managers. On the other hand, geographical diversification can enable better risk-adjusted performance of their private market programs. This article focuses on the UK buyout market and provides a historical analysis of the UK and the global LBO market performance and furthers the discussion around benefits of international diversification in private market investments.



¹ See Hohberg & Rauh (2011) for US institutional investors and Morkoetter & Schori (2021) for global pool of limited partners.

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We looked at the eFront Insight universe of the 20-year history of quarterly returns of regional pools of LBO funds to quantify the correlation structure between different regions. **Getting exposure to less correlated markets enables the benefits from limited partners diversifying their buyout portfolios away from their local region.** As shown in Table 1, the observed buyout funds investing in large regions such as Western Europe and the U.S. exhibited comparatively higher correlation of performance with the UK focused LBO funds. Investing further away in the APAC region or searching in the direction of specific European subregions provides additional diversification benefits.

TABLE 1

Correlation coefficients between the quarterly returns of the eFront Insight universe of funds pooled in the UK and regional LBO markets (in EUR)

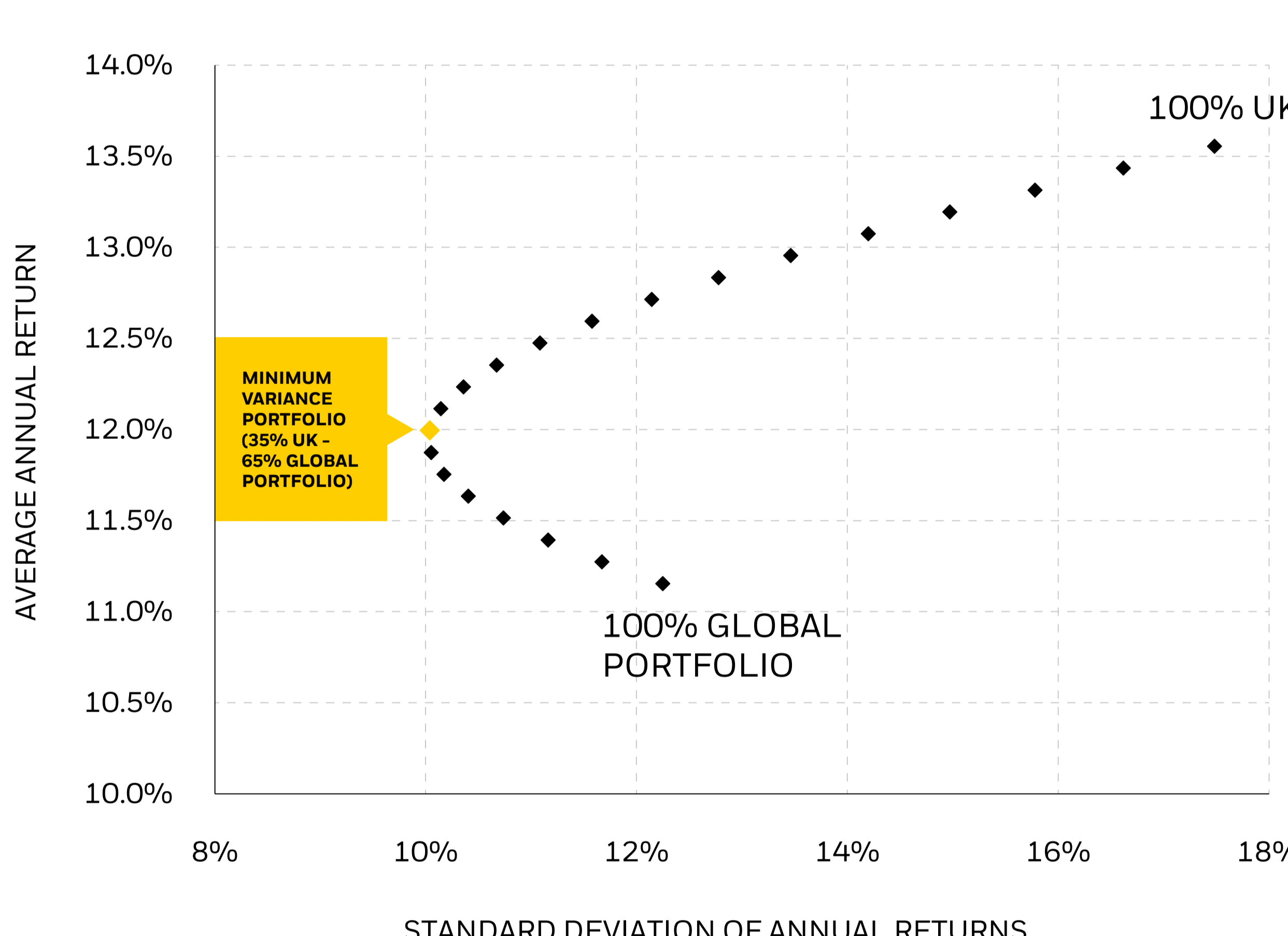
Correlation with UK LBO returns (in EUR)	
WE	0.83
US	0.76
SCANDINAVIA	0.76
FRANCE	0.69
DACH	0.65
SOUTHERN EUROPE	0.64
APAC	0.58

Source: eFront Insight, As of Q2 2021. The table shows the correlation coefficients between quarterly returns in different geographical regions with common historical span (Q1 2001-Q2 2021). An end-to-end return calculation is a standard IRR calculated over a set quarterly period rather than since inception. The starting period for an end-to-end IRR will convert the ending NAV to a negative value and consider it as the initial cash flow. All the returns are net of fees. The currency used is EUR. The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results and should not be the sole factor of consideration when selecting a product or strategy.

A look at the efficient frontier supports the theory that **investing in lower correlated markets improves the risk-return profile of a portfolio.** Figure 1 contrasts the historical average of annual returns and standard deviation of returns for two portfolios representing the eFront universe based on the portfolio deal location, the pure UK focused buyout portfolio and the constructed global portfolio mix (50% committed to the US focused LBO funds, 30% to Western European funds and 20% to APAC).

FIGURE 1

Efficient frontier for the portfolios combining the eFront Insight universe of UK focused LBO funds and the constructed Global portfolio mix (50% US, 30% Western European and 20% APAC focused eFront Insight universe of LBO funds)

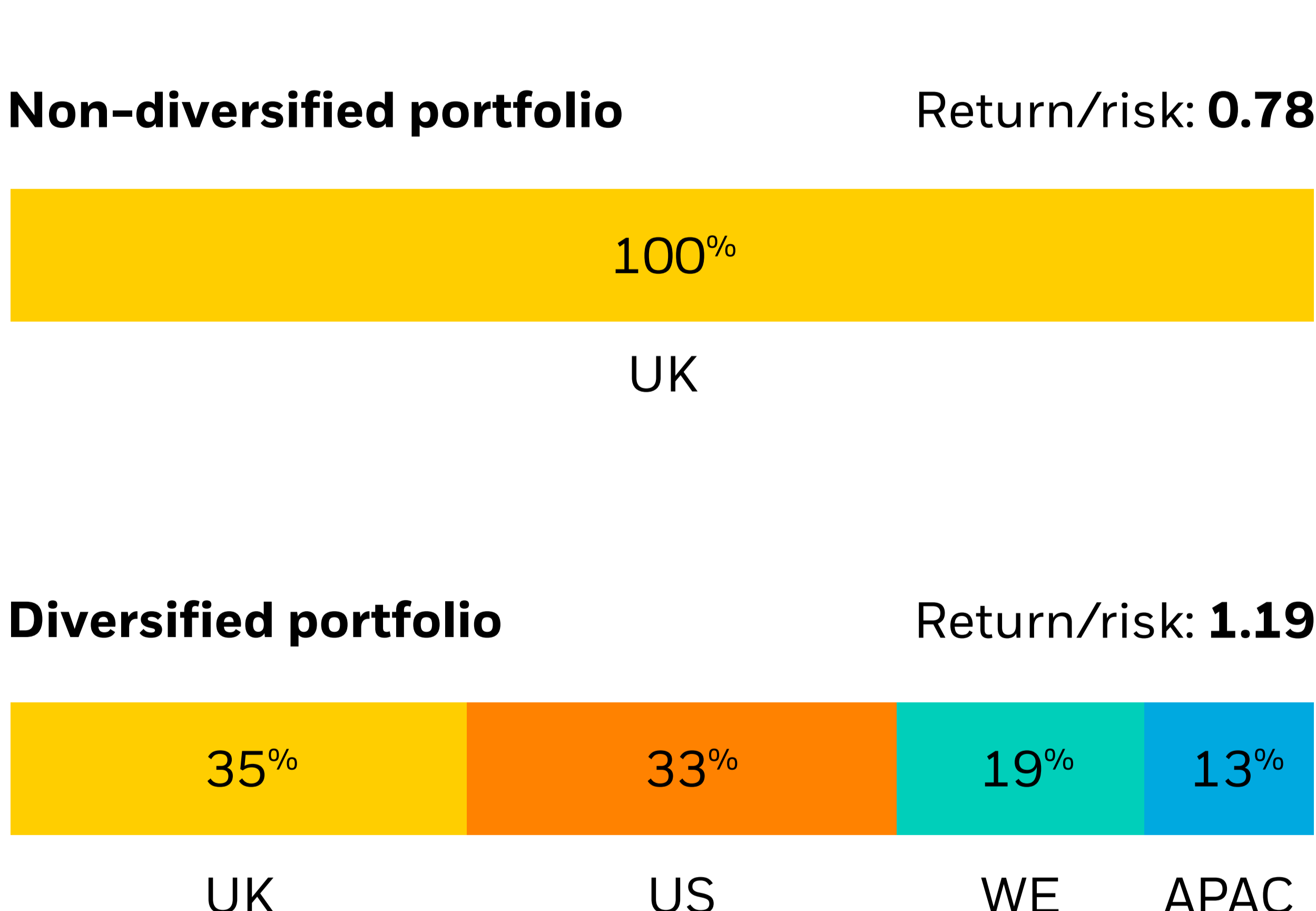


Source: eFront Insight, As of Q2 2021. The chart displays the efficient frontier based on the correlation coefficients between quarterly returns in different geographical regions with common historical span (Q1 2001- Q2 2021) by varying portfolio weights between the UK and the constructed Global portfolio pools of eFront Insight universe of funds so that they add up to 1. An end-to-end return calculation is a standard IRR calculated over a set quarterly period rather than since inception. The starting period for an end-to-end IRR will convert the ending NAV to a negative value and consider it as the initial cash flow. All the returns are net of fees. The currency used is EUR. The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results and should not be the sole factor of consideration when selecting a product or strategy.

Zooming in on the minimum variance portfolio that represents 35% of total capital invested in the UK market and the remaining 65% in the constructed global portfolio shows that there is a **significant increase in the achieved average return per unit of risk, improving from 0.78 to 1.19.**

FIGURE 2

Comparison of the historical realizations of the risk-return profiles of eFront Insight universe of regional portfolios



Source: eFront Insight, As of Q2 2021. The chart displays the risk-return profiles based on historical realizations of the quarterly returns in different geographical regions with common historical span (Q1 2001- Q2 2021). An end-to-end return calculation is a standard IRR calculated over a set quarterly period rather than since inception. The starting period for an end-to-end IRR will convert the ending NAV to a negative value and consider it as the initial cash flow. The risk is calculated as an annualized standard deviation of quarterly IRR returns. All the returns are net of fees. The currency used is EUR. The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results and should not be the sole factor of consideration when selecting a product or strategy.

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