London Borough of Hillingdon Pension Fund
Adams Street Partners Update: Fourth Quarter 2012

Industry Update

Since we are reporting year-end 2012 data, let's take a look back at returns for the fourth quarter and the calendar year. The global public stock markets posted mixed returns in the fourth quarter, as evidenced by the Dow Jones Industrial Average trading down 2.5% versus the Japanese Nikkei rising nearly 18%. Although the Nikkei's return was an extreme outlier and was helped by a rapid depreciation in the Japanese yen, its quarterly return was indicative of the volatility experienced in most public markets in 2012. Nearly all of the major market indices were positive for the calendar year as the US (S&P 500 +16%), Europe (MSCI Europe +20%) and Asia (Hang Seng and Nikkei both up 22%) each posted strong returns. However, these returns were not achieved in a smooth upward slope during the year, as periods of volatility followed various worldwide events. During the last 15 to 18 months markets have been disrupted by major elections in the US, France and Japan (among others), an ECB banking and currency crisis, US government political stand-offs (such as the fiscal-cliff and budget sequesters) and a natural disaster striking the world's busiest stock market (Hurricane Sandy). As much as we would like to think the tough issues are behind us, markets will continue to fluctuate as the majority of the world's developed markets debate actions to address budget deficits, banking woes in Europe (most recently Cyprus) continue to strain the Euro, and tensions/conflicts in the middle-east and North Korea escalate. However, the bad news has been somewhat offset by the low interest rate environment in most developed markets, strong corporate profits reported in many organizations globally and a shift into riskier assets by investors as institutions seek greater returns from their portfolios.

Portfolio Statistics as of December 31, 2012

	Inception Date	Committed / Subscription	Drawn / Subscription	Drawn / Committed	Total Value / Drawn	IRR Since Inception*	Public Market	3Q12 Gross IRR
Total Hillingdon Portfolio	**02/2005**	**99%**	**81%**	**82%**	**1.18x**	**6.89%**	**2.98%**	**2.94%**
2005 Subscription	02/2005	100%	88%	88%	1.21x	6.98%	2.89%	2.62%
2006 Subscription	01/2006	100%	83%	83%	1.15x	6.08%	3.00%	2.53%
2007 Subscription	01/2007	100%	73%	73%	1.20x	9.87%	4.72%	3.12%
2009 Subscription	01/2009	78%	42%	54%	1.15x	19.33%	9.92%	4.34%
Direct Co-Investment Fund	09/2006	100%	96%	96%	1.05x	2.41%	0.56%	4.29%
Co-Investment Fund II	01/2009	100%	49%	49%	1.40x	31.65%	9.58%	5.91%

*Gross of client's management fees paid to Adams Street Partners, LLC.

Note: The Public Market is the equivalent return achieved by applying Hillingdon's cash flows to the MSCI World Index.

Main Drivers of Performance

So what does the volatility mean for the private portfolios that we manage on behalf of our clients? Historically, the General Partners (GPs) have been relatively conservative in the valuation of their portfolios and have been much quicker to write down the value of a poor performing portfolio company than to write up a strong performer. Many GPs are now using more sophisticated mark-to-market applications for updating valuations than what had been used in the past, and they normally incorporate some variation of a public market comparable. Over the past dozen years we have observed the quarterly and one-year valuation changes in the private market funds we manage relative to the public markets. The results indicate that although they tend to move directionally consistent with one another, the magnitude of quarterly price changes in the public markets has been larger than those of our private market portfolios – even on an industry by industry basis. This was particularly evident in 2008 as the public markets faltered after Lehman collapsed, while the private market funds were down but less dramatically.

On the other hand, over longer periods of evaluation (3 to 5 years) the returns of our private market portfolios have consistently exceeded public market returns. Although the portfolios have unrealized valuations adjustments over the short-term, longer term period portfolio valuation changes tend to be more meaningful and are often the result of company liquidations in the form of a sale or IPO. In most cases, the holding valuation just prior to an exit event is below the final realized value. As privately held portfolio companies mature, the rates of return realized upon their sale normally exceed public market returns over a comparable time period. Thus, the exceptional returns that are associated with and expected from private equity investments tend to come from realized portfolio company sales, rather than the quarterly fluctuations of intra-period estimates.

Portfolio Outlook

There are several points to note from these observations. Firstly, our private equity funds' performance in shorter periods of high public market volatility has generally been tempered in both directions relative to those of public market returns. Secondly, over longer periods we have outperformed the public markets as investments mature and returns are realized through portfolio company sales. Lastly, quarterly observations of private equity valuation movements generally underestimate the true economic volatility of the investments themselves. This third point applies to many asset classes that report only quarterly mark-to-market valuations and is because intra-period market "noise" is not observable due to the lack of data points. The lack of liquidity that exists in private markets, in addition to appraisal-based valuations, results in a return series that exhibits artificially low volatility over time. Similar characteristics have been observed in real estate, timber, and hedge funds for example. Adams Street Partners' Advanced Analytics Team has incorporated a quantitative methodology for "un-smoothing" quarterly returns in order to more accurately represent intra-period volatility. This framework is being used as part of the team's ongoing research into risk analysis and the interaction of private equity with other asset classes. Even after adjusting for these factors, we expect the volatility of our portfolios to be on par with the public markets.