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ADAMS STREET - 10 YEARS OF FUND OF FUNDS INVESTING

# A measured approach

*Funds of funds have had to adapt to private equity's global expansion. Hanneke Smits, chief investment officer at Adams Street Partners, explains how*

The macroeconomic situation facing fund of funds managers today may seem very different from that of a decade ago, but there are a few common threads. “This morning I looked back at some slides from 2001 – when we were just coming out of the dotcom bubble – and everyone was talking about the same things,” says Hanneke Smits, chief investment officer of nearly 40-year-old fund of funds manager Adams Street. Then, as now, the talk was of a period of lacklustre growth, forcing GPs to focus on adding value to portfolio companies through operational improvements. Talk of disappointing performance in recent years, as well as capital overhang concerns, are also reminiscent of the years following the tech bubble, notes Smits.

## CHANGING WITH THE TIMES

The role of fund of funds has clearly changed enormously over the past decade, however. Institutions turned to fund of funds in part to gain access to elite, oversubscribed managers (a tactic still in use today in some parts of the market – top-tier US venture funds, for example). But investors also turned to fund of funds for practical reasons: for instance, a small- or even mid-sized pension fund typically won't have the resources to maintain long-term relationships and perform effective due diligence.

The \$13.4 billion State Universities Retirement System of Illinois is a good example: for many years it has relied on Adams Street (as well as fellow fund of funds Pantheon) to make its private equity investments. “We have a small staff and so we don't have the private equity knowledge in-house to oversee a direct programme,” chief investment officer Daniel Allen told *Private Equity International* in 2010. This is also true of many new investors to the asset class – including those from non-US developed markets, which, according to Smits, now account for almost 40 percent of the firm's client base (up from 14 percent in 2001).

For some institutional investors, particularly those with relatively mature private equity portfolios, the trend over the past decade has been to grow in-house capabilities, while outsourcing specific strategies to fund of funds when they don't have the resources or relationships to evaluate managers, says Smits. Emerging markets would be one example, she suggests, or secondary and co-investment programmes, both of which have become much more popular with investors in recent years. Here, specialist knowledge becomes particularly important – “especially for a new LP”, says Smits, since buying directly into assets can be much more complex than making primary fund investments.



*Smits: investors demand customisation*

“We want to be settlers, not pioneers”

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With customisation the order of the day, there has also been a growing demand for separate accounts, raising the question of fiduciary discretion: some of these accounts are structured so that the fund of funds or advisor conducts due diligence and maintains GP relationships, but final investment decisions are made by the client. However, Smits says Adams Street has avoided such arrangements, primarily because a programme dictated by the client “hasn’t always produced the best returns”.

### GOING GLOBAL

In 2001, most of Adams Street’s clients were from developed markets, largely the US and increasingly from Europe, Japan and Australia, but it’s not just Adams Street’s investor base that has become more global in the past decade. Its investment focus has, too. Ten years ago, its allocation was probably split 85/15 between US and European managers, says Smits, whereas today it is 60 percent US, 30 percent European and around 10 percent to emerging markets like China, Central and Eastern Europe, Brazil and Russia. The US and European component are likely to decrease in coming years as the firm continues to find interesting opportunities in emerging markets.

However, its entrance to new markets has been – quite deliberately – very measured.

“We don’t need to be first,” says Smits. “We want to be settlers, not pioneers.”

Take Asia, for example. Piau-Voon Wang, now the firm’s head of Asian operations, was hired in 1999. Soon afterwards Smits and Wang began regularly visiting the region; reflecting on the first year, she recalls, “We spent eight weeks on the road over a one-year period and interviewed 150 managers.” They made a shortlist of promising GPs and kept coming back to meet them, eventually making their first Asian investment in 2003. Some of the managers they established relationships with are now among the most highly regarded in the region, including China-focused CDH Investments and Indian fund manager ChrysCapital. The firm went on to open offices in Singapore in 2006 and Beijing in 2011.

This disciplined approach is not unique to Asia, says Smits. She jokes that Sergey Sheshuryak, another partner who joined the firm in 1999, is known internally as their “Russian colleague who kept us from investing in Russia” for years. The reason, she says, is simply that it took time to understand how to price the risk inherent in that market appropriately. After years of research, the firm made its first Russian investment in 2007 to Baring Vostok. It was a similar story with CEE, where it first invested in 2006, and Latin America,

where its first investment came in 2009. It’s currently looking at future opportunities in Africa, says Smits.

### THE ROAD AHEAD

While there are clearly new and interesting territories ahead for fund of funds, the path isn’t straightforward. Smits expects the next three years to be particularly tough in light of macroeconomic conditions – which in her view will inevitably impact returns. “Some managers will be lucky to produce 8 percent returns,” she says. That may beat public markets returns of around 6 percent; but “once you factor in fees”, some investors may question the wisdom behind their private equity programmes. So it’s important for fund of funds managers to deliver attractive net performance. Adams Street, for its part, is projecting returns of 12-15 percent net in coming years.

Still, that will be no easy feat given it will also become more difficult to put capital to work, Smits believes. “Fundraising today is tough. As a result many managers are raising smaller funds, while some may not be able to raise funds at all. “That’s yet another reason why all that disciplined research into new territories is crucial: it will become increasingly important to have already established relationships with tomorrow’s rising stars. 🌸