



**FIRST STATE INDEPENDENCE FUND I, LLC**

Financial Statements

December 31, 2012 and 2011

(With Independent Auditors' Report Thereon)

# FIRST STATE INDEPENDENCE FUND I, LLC

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KPMG LLP  
1601 Market Street  
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## Independent Auditors' Report

The Members of the Board of Pensions Trustees  
First State Independence Fund I, LLC:

### Report on the Financial Statements

We have audited the accompanying financial statements of the First State Independence Fund I, LLC (the Fund), which comprise the statements of fund net position as of December 31, 2012 and 2011, and the related statements of changes in fund net position for the years then ended, and the related notes to the financial statements.

### *Management's Responsibility for the Financial Statements*

Management is responsible for the preparation and fair presentation of these financial statements in accordance with U.S. generally accepted accounting principles; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

### *Auditors' Responsibility*

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditors consider internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

### *Opinion*

In our opinion, the financial statements referred to above present fairly, in all material respects, the statements of fund net position of First State Independence Fund I, LLC as of December 31, 2012 and 2011, and the statements of changes in fund net position for the years then ended, in accordance with U.S. generally accepted accounting principles.



### ***Emphasis of Matter***

As described in note 1 to the financial statements, in April 2012, the board of trustees approved the liquidation of the First State Independence Fund I, LLC by the fund manager and the remaining assets represent not readily marketable and holdback assets not yet realized.

### ***Other Matters***

#### ***Required Supplementary Information***

U.S. generally accepted accounting principles require that Management Discussion and Analysis be presented to supplement the financial statements. Such information, although not a part of the financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

#### ***Supplementary and Other Information***

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the Fund's financial statements. The supplementary schedules on pages 11 to 12 are presented for purposes of additional analysis and are not a required part of the financial statements.

The supplementary schedules are the responsibility of management and were derived from and relate directly to the underlying accounting and other records used to prepare the financial statements. Such information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the supplementary schedules are fairly stated in all material respects in relation to the financial statements as a whole.

### ***Other Reporting Required by Government Auditing Standards***

In accordance with *Government Auditing Standards*, we have also issued our report dated October 16, 2013 on our consideration of the Fund's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Fund's internal control over financial reporting and compliance.

**KPMG LLP**

October 16, 2013

# FIRST STATE INDEPENDENCE FUND I, LLC

## Management's Discussion and Analysis

December 31, 2012 and 2011

(Unaudited)

### Introduction and Recent Developments

This section of the financial statements of the First State Independence Fund I, LLC (the Fund) presents our discussion and analysis of the Fund's financial performance during the periods ended December 31, 2012 and 2011. As this discussion and analysis is designed to focus on current activities, it should be read in conjunction with the Fund's basic financial statements, which follow this section.

In April 2012, the Board approved the liquidation of the Fund by the fund manager. All fund managers received notices on or before July 1, 2012 to liquidate their positions. Remaining assets represent not readily marketable and holdback assets that will be realized at the individual fund manager's discretion.

### Financial Statements

The Fund's basic financial statements include the statement of fund net position and statements of changes in fund net position, which have been presented in accordance with U.S. generally accepted accounting principles as applicable to governmental entities.

The statement of fund net position provides information on the financial position of the Fund at year-end. The statement of changes in fund net position presents the results of the investing activities during the period. The notes to the financial statements offer additional discussion that is essential to the full understanding of the data presented in the financial statements. The notes give more detail about accounting policies, significant account balances and activities, material risks, obligations, contingencies, and subsequent events, if any. The financial statements and related notes are prepared in accordance with Governmental Accounting Standards Board principles as applicable to governmental entities.

### Statement of Fund Net Position

The statement of fund net position presents the assets, liabilities, and net position (assets minus liabilities) of the Fund as of the end of the fiscal year and is a point in time financial statement. The statement of fund net position comprises the following major components:

	<u>2012</u>	<u>2011</u>	<u>2010</u>
	(Dollar values expressed in thousands)		
Cash and equivalents	\$ —	5,321	21,296
Receivables	5,110	2,649	11,527
Investments	243	144,588	173,127
Accrued expenses	—	(360)	(442)
Net position	<u>\$ 5,353</u>	<u>152,198</u>	<u>205,508</u>

## FIRST STATE INDEPENDENCE FUND I, LLC

### Management's Discussion and Analysis

December 31, 2012 and 2011

(Unaudited)

#### Statement of Changes in Fund Net Position

Changes in fund net for each year are presented in the statement of changes in fund net position. The purpose of this statement is to present the net investment income earned by the Fund as well as contributions from members and distributions to members or service providers. A summary is as follows:

	<u>2012</u>	<u>2011</u>	<u>2010</u>
	(Dollar values expressed in thousands)		
Investment income	\$ 4,258	(6,114)	9,691
Net capital (distributions to) contributions from investor	<u>(151,103)</u>	<u>(47,196)</u>	<u>1,704</u>
Change in net position	<u>\$ (146,845)</u>	<u>(53,310)</u>	<u>11,395</u>

The change in net position for the years ended December 31, 2012 and 2011 was \$(146,845) thousand and \$(53,310) thousand, respectively. The change in net position from the period ended December 31, 2011 and 2012 was primarily attributed to distributions to the investor. The distributions to the investor during the years ended December 31, 2012 and 2011 were a result of redemptions and the Board approved partial liquidation of the Fund in 2011 and the subsequent full liquidation of the Fund in 2012.

#### Investment Performance

The investment objective of the Fund was to realize an annual total investment return exceeding the S&P 500 Index over a full market cycle, net of fees. The Fund's strategy was to invest in long/short equity hedge funds (underlying funds). The investment performance for the Fund lagged major indexes significantly for the years ended December 31, 2010, 2011, and 2012. The 2010, 2011, and 2012 underperformance was attributed to the investment managers' hedges and short positions, which detracted from returns during a rising equity market. It is the fund's short positions and defensive posture that generally cause the fund to underperform in rising markets and over-perform in falling markets. In 2012, the Fund's performance was driven by the full liquidation of fund managers resulting in temporary cash balances in the Fund before these balances were transferred to the Delaware Public Employees' Retirement System. The rate of return for the Fund is calculated as the net increase/decrease in net position, excluding capital transactions of the investor, divided by net position at the beginning of the year. The Fund's rate of return and various market indices are as follows:

	<u>2012</u>	<u>2011</u>	<u>2010</u>
	<u>1 year</u>	<u>1 year</u>	<u>1 year</u>
Total rate of return	3.3%	(3.0)%	5.0%
Returns of various market indices (%):			
S&P 500	16.0%	2.1%	15.1%
MSCI world	16.5	(5.0)	12.4

**FIRST STATE INDEPENDENCE FUND I, LLC**

Statements of Fund Net Position

December 31, 2012 and 2011

	<u>2012</u>	<u>2011</u>
Assets:		
Cash and cash equivalents	\$ —	5,321,416
Receivables:		
Accrued interest income	—	5
Pending trade sales	5,109,848	2,288,650
Receivable from DPERS	—	360,427
Total receivables	<u>5,109,848</u>	<u>2,649,082</u>
Investments at fair value:		
Alternative investments	242,867	144,587,692
Liabilities:		
Accrued investment expenses	—	(360,427)
Net position	<u>\$ 5,352,715</u>	<u>152,197,763</u>

See accompanying notes to financial statements.

**FIRST STATE INDEPENDENCE FUND I, LLC**

Statements of Changes in Fund Net Position

Years ended December 31, 2012 and 2011

	<u>2012</u>	<u>2011</u>
Investment income	\$ 5,152	16,847
Net appreciation (depreciation) in fair value of investments	4,830,945	(4,526,835)
Less investment manager fees	<u>(578,030)</u>	<u>(1,603,780)</u>
Net investment gain (loss)	4,258,067	(6,113,768)
Capital contributions from investor	578,030	1,603,780
Distributions to investor	<u>(151,681,145)</u>	<u>(48,800,000)</u>
Net decrease	(146,845,048)	(53,309,988)
Balance at beginning of year	<u>152,197,763</u>	<u>205,507,751</u>
Balance at end of year	<u>\$ 5,352,715</u>	<u>152,197,763</u>

See accompanying notes to financial statements.

## FIRST STATE INDEPENDENCE FUND I, LLC

Notes to Financial Statements

December 31, 2012 and 2011

### (1) Organization and Liquidation of the Fund

The Board of Pension Trustees (the Board) of the Delaware Public Employees' Retirement System (DPERS or the System) manages the First State Independence Fund I, LLC (the Fund), which was formed on June 25, 2008 and commenced operations on July 1, 2008. The System is the sole member of the Fund. The operations of the Fund are governed by the Board, including the determination of authorized investments for the Fund. Daily operation of the Fund is the responsibility of the State of Delaware Office of Pensions. The Fund is not registered with the Securities and Exchange Commission (SEC) as an investment company.

The Fund was formed for the object and purpose of increasing the investment return on assets of the pension plans of DPERS. The investment objective of the Fund was to realize an annual total investment return exceeding the S&P 500 Index over a full market cycle, net of fees. The investment strategy was to invest in long/short equity hedge funds (underlying funds).

The Fund is a blended component unit of the DPERS and the assets of the Fund are included in the financial statements of the System.

The accompanying financial statements present only the Fund and do not purport to, and do not, present fairly the financial position of the System as of December 31, 2012 and 2011, and changes in its financial position for the years then ended, in conformity with U.S. generally accepted accounting principles.

#### *Liquidation of the Fund*

In April 2012, the Board approved the liquidation of the Fund by the fund manager. All fund managers received notices on or before July 1, 2012 to liquidate their positions. Remaining assets represent not readily marketable and holdback assets that will be realized at the individual fund manager's discretion.

#### *Taxes*

The fund is exempt from taxation under Section 115 of the Internal Revenue Code.

### (2) Summary of Significant Accounting Policies

#### (a) *Basis of Accounting*

The financial statements are reported using the economic resources measurement focus and the accrual basis of accounting, in conformity with U.S. generally accepted accounting principles. Under this method, revenues (additions) are recorded when earned and expenses (deductions) are recorded at the time liabilities are incurred, regardless of when the related cash flows take place.

#### (b) *Cash and Cash Equivalents*

Cash and cash equivalents include all cash balances and highly liquid investments with original maturities of less than three months.

#### (c) *Investment Valuation*

Investments in underlying funds are stated at estimated fair value in accordance with procedures established by management, based on information received directly from the underlying fund

## FIRST STATE INDEPENDENCE FUND I, LLC

### Notes to Financial Statements

December 31, 2012 and 2011

managers and third-party administrators. There has been no change in investment valuation methods as a result of the liquidation of the Fund.

The fair value of the Fund's interest in an underlying fund will represent the amount that the Fund could reasonably expect to receive from an underlying Fund or from a third party if the Fund's interest were redeemed or sold at the time of valuation, based on information reasonably available at the time the valuation is made and that the Fund's management believes to be reliable. These investments are redeemable with the underlying funds at net asset values under the original terms of the partnership agreements and/or subscription agreements and operations of the underlying funds. However, it is possible that these redemption rights may be restricted or eliminated by the underlying funds in the future in accordance with the underlying funds agreements. Due to the nature of the investments, their estimated value is subject to uncertainty and therefore may differ significantly from the value that would be used if a ready market for such investments existed. Accordingly, the realized value upon sale of the asset may differ from the fair value. Furthermore, changes to the liquidity provisions of the underlying funds may significantly impact the fair value of the Fund's interests. Under some circumstances, the Fund may determine, based on other information available, that an underlying investment's reported valuation does not represent fair value.

#### **(d) Investment Transactions**

Investment transactions are accounted for on a trade- or investment-date basis. Gains or losses from investment transactions are determined by the average cost method. Net appreciation or depreciation in fair value of investments includes net realized gains and losses and the change in net unrealized gains and losses on investments for the fiscal year then ended. The net realized gain (loss) from investment transactions amounted to \$18,042,971 and \$(1,902,397) and the net increase (decrease) in unrealized gains (losses) was \$(13,212,026) and \$(2,624,438), resulting in total net appreciation (depreciation) in fair value of \$4,830,945 and \$(4,526,835), for the years ended December 31, 2012 and 2011, respectively.

#### **(3) Related-Party Transactions**

The sole member and manager of the Fund is the System, which directs in interparty transfers. \$578,030 and \$1,603,780 was transferred in from the System and \$151,681,145 and \$48,800,000 was transferred back to the System during the years ended December 31, 2012 and 2011, respectively.

#### **(4) Use of Estimates**

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amount of income and expenses during the reporting period. Actual results could differ from those estimates.

#### **(5) Commitments**

The Fund has purchase commitments totaling \$0 and \$5.2 million as of December 31, 2012 and 2011, respectively.

## FIRST STATE INDEPENDENCE FUND I, LLC

Notes to Financial Statements

December 31, 2012 and 2011

### (6) Investment Advisory Agreement

The Adviser, Barlow Partners Inc. (Barlow), is registered with the SEC as an investment adviser under the Investment Advisers Act of 1940, as amended (Advisers Act). The Adviser acts as a fiduciary to DPERS and has investment discretion over the investments made in the Fund. The Adviser is responsible for identifying what it considers to be attractive investment opportunities and for analysis of investment performance of the underlying funds. Investment advisory services are provided to the Fund by Barlow pursuant to an investment advisory agreement dated June 25, 2008 (the Advisory Agreement). As compensation for services and facilities provided by the Adviser under the Advisory Agreement, the Fund pays the Adviser each quarter a management fee equal to 0.25% (1.0% annually) of the net asset value of the Fund as of the end of each fiscal quarter. The Fund paid Barlow \$578,030 and \$1,603,780 in management fees for the years ended December 31, 2012 and 2011, respectively. The investment advisory agreement with Barlow was terminated on June 30, 2012.

The Fund indirectly bears fees and expenses as an investor in the underlying funds.

### (7) Administrative Expense

DPERS pays for the administrative expenses of the Fund (accounting, legal, organizational) from its resources.

### (8) Investments

The following table lists the Fund's investments in underlying funds (all of which are invested principally in marketable equity securities) as of December 31, 2012 and 2011, none of which was a SEC-registered investment:

Investment focus	Market value		Percent allocation	
	2012	2011	2012	2011
Global equity	\$ 242,867	33,308,464	100.0%	23.0%
Value	—	20,440,123	—	14.1
Global value	—	14,973,295	—	10.4
U.S. equity	—	14,248,226	—	9.9
Global technology	—	12,634,124	—	8.7
Industrials/technology	—	9,691,915	—	6.7
Large cap growth	—	9,372,186	—	6.5
Consumer	—	9,135,609	—	6.3
Small/mid cap value	—	9,086,555	—	6.3
Small cap growth	—	6,342,580	—	4.4
European equity	—	5,354,615	—	3.7
	<u>\$ 242,867</u>	<u>144,587,692</u>	<u>100.0%</u>	<u>100.0%</u>

## **FIRST STATE INDEPENDENCE FUND I, LLC**

### Notes to Financial Statements

December 31, 2012 and 2011

There are no state statutes limiting allowable investments for the Fund. The investment decisions are dictated by the prudent person rule and internal investment guidelines established by the Board, in furtherance of the Fund's investment objectives. For the fiscal years ended December 31, 2012 and 2011, management of the Fund believes that it has operated in all material respects in accordance with Board guidelines.

Investments are typically subject to various risks. Among these risks are credit risk, concentration of credit risk, custodial credit risk, interest rate risk, and foreign currency risk. Each one of these risks is discussed in more detail below.

Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. The credit risk of a debt instrument is evaluated by nationally recognized statistical rating agencies such as Moody's Investors Service, Inc., Standard & Poor's, and Fitch Ratings. Concentration of credit risk is the risk of loss attributed to the magnitude of an investment in a single issuer. Interest rate risk is that risk that changes in interest rates will adversely affect the fair value of an investment. Foreign currency risk is the risk that changes in exchange rates will adversely affect the fair value of an investment.

The Fund's investments in underlying funds are not represented by debt instruments and are not denominated in foreign currencies. As such, none of the above risks apply directly to Fund investments. However, the Fund's investments in underlying funds may contain elements of credit, currency, and market risk. Such risks include, but are not limited to, limited liquidity, absence of regulatory oversight, dependence on key individuals, use of leverage, emphasis on speculative investments, and nondisclosure of portfolio composition. Information about the investments held by the underlying funds is not readily available, so it is unknown whether the Fund holds any single investment whereby the Fund's proportionate share exceeds 5% of the Fund's net position at December 31, 2012 and 2011.

**Custodial Credit Risk:** The Fund's \$0 and \$82,312 bank balance represents deposits in short-term investments held by The Northern Trust Co., the custodian bank, as of December 31, 2012 and 2011, respectively. Of the Fund's bank balance, \$250,000 is insured by the Federal Deposit Insurance Corporation (FDIC).

**FIRST STATE INDEPENDENCE FUND I, LLC**

## Schedule of Investments

December 31, 2012

<b>Fund</b>	<b>Cost</b>	<b>Unrealized gain (loss)</b>	<b>Fair value, December 31, 2012</b>
Brookside Capital Partners Fund, LP	\$ 6,848	(2,734)	4,114
Valinor Capital Partners, LP	117,140	121,613	238,753
Total	\$ 123,988	118,879	242,867

See accompanying independent auditors' report.

**FIRST STATE INDEPENDENCE FUND I, LLC**

## Schedule of Investments

December 31, 2011

<u>Fund</u>	<u>Cost</u>	<u>Unrealized gain (loss)</u>	<u>Fair value, December 31, 2011</u>
Addison Clark Fund	\$ 8,400,000	686,555	9,086,555
AKO Partners	5,500,000	(145,385)	5,354,615
Bluefin Investors, LP	7,000,000	(657,420)	6,342,580
Brookside Capital Partners Fund II, LP	13,696,562	(2,161,127)	11,535,435
Brookside Capital Partners Fund, LP	6,848	559	7,407
Coatue Qualified Partners, LP	10,000,000	2,634,124	12,634,124
D. Gordon Partners, LP	9,000,000	135,609	9,135,609
Greenlight Capital Qualified, LP	10,000,000	4,973,295	14,973,295
J. Hilsabeck Partners, LP	9,500,000	191,915	9,691,915
MSG Partners, LP	15,000,000	(751,774)	14,248,226
Otter Creek Partners I, LP	8,700,000	9,890	8,709,890
Pershing Square, LP	7,585,514	4,144,719	11,730,233
Seminole Capital Partners, LP	9,000,000	372,186	9,372,186
Valinor Capital Partners, LP	4,000,000	626,399	4,626,399
Viking Global Equities, LP	13,867,863	3,271,360	17,139,223
Total	<u>\$ 131,256,787</u>	<u>13,330,905</u>	<u>144,587,692</u>

See accompanying independent auditors' report.



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**Independent Auditors' Report on Internal Control over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with *Government Auditing Standards***

The Members of the Board of Pension Trustees  
First State Independence Fund I, LLC:

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, the financial statements of First State Independence Fund I, LLC (the Fund), which comprise the statements of fund net position as of December 31, 2012 and 2011, and the related statements of changes in fund net position for the years then ended, and the related notes to the financial statements, and have issued our report thereon dated October 16, 2013, which contained an Emphasis of Matter paragraph on the liquidation of the Fund.

**Internal Control over Financial Reporting**

In planning and performing our audit of the financial statements, we considered the Fund's internal control over financial reporting to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Fund's internal control. Accordingly, we do not express an opinion on the effectiveness of the Fund's internal control.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A material weakness is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit, we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.



## **Compliance and Other Matters**

As part of obtaining reasonable assurance about whether the Fund's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

## **Purpose of This Report**

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the Fund's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Fund's internal control and compliance. This report is intended solely for the information and use of management, the Board of Pension Trustees, Secretary of Finance, Office of the Controller General, Office of the Attorney General, Office of the Governor, and the Office of Management and Budget, and is not intended to be and should not be used by anyone other than these specified parties. However, under 29 Del C., Section 10002(1), this report is public and its distribution is not limited.

**KPMG LLP**

October 16, 2013