



Dear Members of the Harvard Community,

I'm writing to share with you the performance of the Harvard endowment for fiscal year 2017 and to provide an update on our progress since my January letter.

For the fiscal year ended June 30, 2017, the return on the Harvard endowment was 8.1% and the value of the endowment was \$37.1 billion. Performance reflects strong returns from public equity, private equity, and our direct real estate platform, while natural resources experienced a challenging year. We also executed secondary sales in real estate and private equity that generated significant liquidity for the endowment.

The State of HMC

Our performance is disappointing and not where it needs to be. Indeed, the opportunity to improve this is what attracted me to the leadership role of Harvard Management Company. The endowment's returns are a symptom of deep structural problems at HMC and the resultant significant issues in the portfolio. These matters have challenged HMC for years, despite a highly talented and dedicated team of professionals and active support from the University and the HMC Board of Directors. The problems highlight the critical impact of culture, structure, and incentives in an investment organization.

I believe strongly that an honest, reflective, and clear-sighted recognition of these problems is the first critical step towards generating solutions. It is an unfortunate truth that the issues that have impacted HMC and its performance in the past will continue to negatively impact returns in the near term and will require time to overcome.

As a fourteen-year leader of a highly successful endowment, it is my firm conviction that a talented and skilled team supported and guided by the right organizational and investment culture, and properly incentivized, will overcome legacy issues and produce strong long-term results.

When I took this position, it was clear to me that the time had come for an aggressive plan to restructure HMC and create the necessary organizational and investment culture. Accordingly, my first seven months included establishing a generalist investment model, recruiting new senior investment team members, integrating existing team members from the previous silo model and new team members (including myself) into our generalist model, spinning off various internal platforms and preparing to spin off others, rebuilding our investment processes and analytics, creating a new risk framework, generating meaningful liquidity, and designing our new compensation framework. In a perfect world, we would have moved through these changes over a much longer period. However, given the time needed for these changes to impact results, the HMC Board of Directors and I strongly believe that HMC will be in a far better position by moving quickly. We have done so.

In my January letter, I touched upon the vision for the future of HMC. This letter provides an update on our progress toward that vision, what has been accomplished, the plan going forward, and the timeframe to be expected.

Organizational Update

Internal Management

As of June 30, 2017, HMC has largely exited internal management of public markets assets. We have based this approach on practical considerations rather than any specific dogma. While internal management generally generates lower fees and expenses, today's market landscape makes it ever more difficult to attract and retain top portfolio managers. I strongly believe that the changes we are making as an organization will produce better returns for Harvard in a more efficient manner over time.

Accordingly, as of June 30, we have made the following moves:

- The relative value platform has shut down. We expect that two of these teams will continue to be external partners to Harvard on a going-forward basis.
- The internally managed equity platform has shut down.
- The credit platform has been repositioned and is currently executing its strategy internally. We expect this team to depart HMC and are working to execute a mutually beneficial arrangement as an external manager.
- The real estate platform responsible for direct investments is also expected to spin out. We are working closely with the team to support this effort and to execute a mutually beneficial arrangement as an external manager.
- The size of the support organization has been reduced as a result of our new investment approach.

As stated in my January letter, the natural resources portfolio will continue to be managed internally. Separately, while we do not expect to rebuild a sizeable internal platform, we will always be opportunistic, and we will innovate when appropriate investment opportunities are identified.

From Silos to Generalist Model

HMC's investment professionals have historically focused their work within specific asset classes. Over time, however, this "silo" approach created unintended consequences. Portfolio managers conducted research and analysis and executed investment decisions within their respective asset class independent of the rest of the portfolio, sometimes creating both gaps in the portfolio and unnecessary duplication. This model also created an overemphasis on individual asset class benchmarks. Overall, I believe the silo approach did not lead to the best investment thinking for a major endowment.

We have now moved our approach towards a generalist investment model in which all members of the investment team take ownership of the entire portfolio. The team will have a singular focus: the performance of the overall endowment. We will engage in focused debate and discussion about investment opportunities, both within asset classes and across the investment universe.

I first experienced the generalist investment model while working at the University of Pennsylvania's endowment and I subsequently brought this approach to Columbia. Other highly successful endowments have used elements of the generalist model, and HMC will create its own version.

Organizational Culture

A successful investment organization is reliant upon the development and execution of an appropriate organizational culture.

Besides the obvious need to strive for excellence and to conduct ourselves with integrity, we seek to build an organization that is highly collaborative and less hierarchical than previously structured. Ultimately, we seek to develop a partnership culture in which colleagues can easily access one another and engage in informal debate. By cultivating ideas from a broad range of team members, we increase the opportunity to make superior investment decisions. This approach will also help maintain high team morale while attracting and retaining top endowment talent.

Investment Culture

A central tenet of our investment culture is the belief that a disciplined set of processes practiced consistently by a highly skilled team will generate superior long-term results. Therefore, a central effort of our team is to build investment processes and supporting analytics, and execute them consistently with high competence. Our objective is to create a common language to consider and evaluate assets across the investment spectrum. Put another way, these processes and analytics will provide the fuel behind the generalist model.

A second central tenet of our investment culture is the belief that a stable organization is critical to investment success. When I departed Columbia, ten of our team members had worked together for eight years or more, with most of us in excess of ten years. By contrast, HMC has experienced several leadership changes during a relatively short period of time. I believe the strong long-term performance of several endowments with consistent senior teams is not a coincidence.

In that context, I have recruited four senior Generalist team members with whom I have an established professional history. We are exceptionally fortunate to have recruited Rick Slocum, whom I have known for thirty-two years, as HMC's first chief investment officer. The newest team members and I are joined by a highly talented and dedicated group of existing HMC colleagues. I look forward to creating longevity and deep familiarity amongst our collective Generalist team.

Compensation

We have created a new compensation framework impacting fiscal year 2018 and beyond.

There are five central tenets to our approach:

1. The framework applies to all HMC staff, excluding any remaining internal management platforms.
2. Compensation will be determined by the performance of the entire portfolio, not any individual silo or sub-portfolio.
3. The framework will ultimately relate to a five-year look back period, thereby incentivizing our team to focus upon medium-term results. (As a practical matter, we will have to build up to a five-year period, starting with fiscal year 2018).
4. Bonuses for Executive and the senior-most Generalist team members will be paid out over a multi-year period. This is a critical feature to align interests.
5. Finally, the program is designed to allow HMC to attract and retain top endowment management talent.

Risk Framework

We have created a new risk allocation framework that will replace the asset allocation approach previously used by HMC. This model is very different from past HMC approaches and we have completed the first phase of building and integrating this framework into our investment decision making.

In managing the University's financial assets, HMC seeks to maximize returns, subject to the risk tolerance established by the University, in consultation with HMC's Board of Directors. We will determine with the University's financial team the appropriate risk level for Harvard. Our dialogue with this team is just beginning and we expect it to grow over time, allowing us to achieve this important understanding and objective.

The risk allocation framework is a management tool for assessing the underlying assets in the portfolio, which:

- Allows us to understand basic exposures in the portfolio, dispensing with common labels, such as hedge funds and private equity.
- Highlights exposures as a portion of portfolio risk, rather than dollars.
- Allows us to estimate the total risk in the portfolio, in order to inform our portfolio actions and our dialogue with the University.
- Makes long-term assumptions (e.g., risk, return, and correlation), thereby avoiding attempts to forecast short-term asset class returns or respond to day-to-day market moves (e.g., short-term volatility targeting).

- Eliminates a policy portfolio in nominal terms, as any risk allocation can be executed with a theoretically infinite set of asset allocations.
- Does not require a policy portfolio even in risk terms as, like many endowments, we have grown highly skeptical of optimizations.

While at Columbia, it was a proud moment on two separate occasions to have the highest ten-year return of any endowment, despite taking less risk than many. That being said, I also consider it to be of limited relevance. HMC's returns will largely be a function of Harvard's chosen risk level and not necessarily related to that of any peers, who might have different risk appetites. Comparisons to other peers are natural, but not productive. In my opinion, misdirected pressures caused by peer return comparisons contributed meaningfully to the challenges experienced by leading endowments during the financial crisis. A more sophisticated lens will always focus first upon risk appetites rather than simply returns.

Timeframe

As I explained in my January letter, the HMC Board of Directors and I expect that it will take a number of years to reposition HMC in order to perform up to our expectations from that point forward. As those highly familiar with endowment investing understand, change takes time. In HMC's case, there are four factors contributing to this timeframe.

First, like most endowments, HMC's portfolio includes some highly illiquid assets, with long duration. Managers of these assets will typically execute a multi-year plan to add value and will only sell the asset upon completion of these efforts. However, the timing of dispositions is not entirely within HMC's control.

Where we could take prudent direct action to reduce exposure, we have done so—and will continue to do so. As an example, HMC successfully executed a sizeable secondary sale of externally managed partnerships in both our real estate and private equity portfolios. Our internal real estate, legal, and portfolio accounting teams were critical in achieving this terrific outcome. This resulted in both a reduction in exposure and generated significant liquidity for our portfolio.

By the same token, meaningfully increasing our exposure to certain other illiquid assets will take a similar multi-year period. We will make commitments to external managers, diversified by vintage year, and will only see our capital drawn and invested over the next few years, at the manager's discretion.

We also have started to make changes in the public markets portfolio. While these changes should take less time, executing them in a prudent manner will take at least two years and perhaps longer.

Second, HMC's former silo model constrained team members to thinking about only small pieces of the overall portfolio. Therefore, some of the best ideas were sized in the context of a sub-portfolio, not the entire endowment. As a result, the portfolio includes investments in many high conviction managers undersized for such a large endowment. Unfortunately, many of these managers (liquid or illiquid) are now closed or in high demand from peer institutions, making HMC's desire to "upsized" exceptionally difficult in the immediate future.

Third, many of the most appealing external managers seek reliable investment partners, whom they believe are stable and aligned with their investment vision. The lack of consistent leadership at HMC over the past several years has complicated this effort. We are now focused on re-establishing HMC as an investment partner of choice.

Fourth, HMC is obviously undergoing substantial philosophical and structural change that will take time to fully absorb into the organization's culture.

We are progressing through each of these highly significant factors simultaneously and their impact on the portfolio will obviously be incremental over time. Ultimately, restructuring illiquid portions of the portfolio requires the longest time to implement. Several of today's best performing endowments have undergone such evolutions over multiple years and ultimately emerged as leaders. HMC will do the same.

Natural Resources

For years, HMC benefited from an internally managed natural resources program that generated strong returns. At this stage, however, while most assets remain attractive, a few have significant challenges.

The HMC Board of Directors took some markdowns on value prior to my arrival, and we have taken more markdowns in fiscal year 2017, which meaningfully impacted our results.

Markdowns do not imply sales. HMC will choose to hold many of the assets if the prospects for forward-looking returns are reasonable. Furthermore, certain assets were sold at or above their previous valuations during fiscal year 2017.

Our natural resources platform will take multiple years to reposition. We are in active dialogue with our largely new and accomplished natural resources team to determine the best path forward with regards to the existing assets and to develop a strategic longer-term plan for the overall natural resources portfolio. As noted previously, the illiquid nature of this portfolio means that change will be incremental and a multi-year process.

Looking Ahead

Since arriving at HMC, I have focused my priorities upon positioning the endowment for better future performance. As investors are well aware, performance can only be meaningfully evaluated over a full market cycle, including inevitable ups and downs. One or even three-year performance is not informative. Our focus at HMC will reflect a longer-term view.

Our primary focus has now shifted to having the Generalist investment team gain a collective understanding of the entire portfolio. As we do so, we will gain proficiency in our new processes and continue to develop the analytics which support them. At the same time, we will make portfolio moves accordingly.

Indeed, my time at Harvard has given me many reasons to be even more optimistic for our future. We are equipped with dynamic investment and support teams and collectively we are driven by our mission to support the educational and research goals of Harvard University. There is certainly much work to be done. However, I am confident that our efforts will ultimately result in a stronger model and improved investment performance that will benefit many future generations of Harvard students, faculty, and staff to come.

Best regards,



N.P. "Narv" Narvekar
Chief Executive Officer