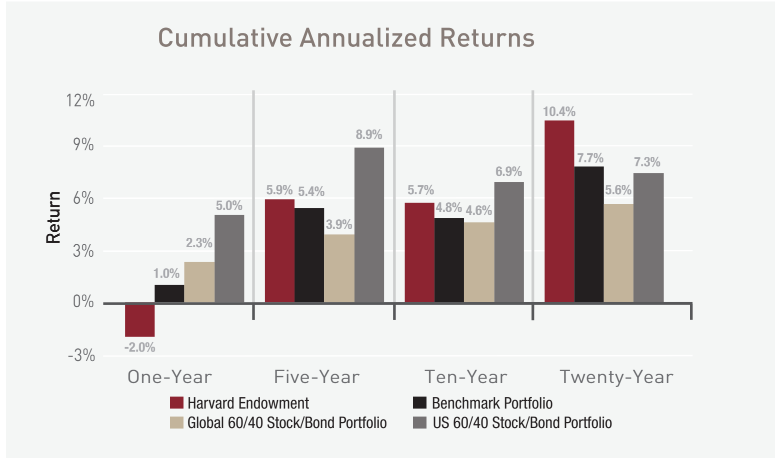
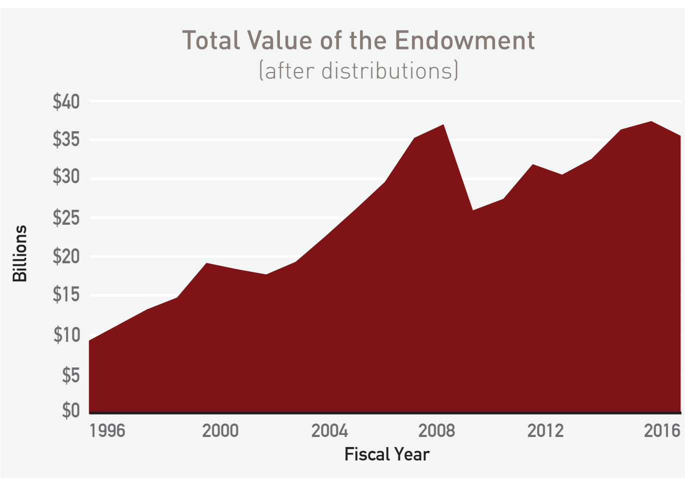
September 2016
Annual Endowment Report
Message from Robert A. Ettl, President and CEO

Introduction

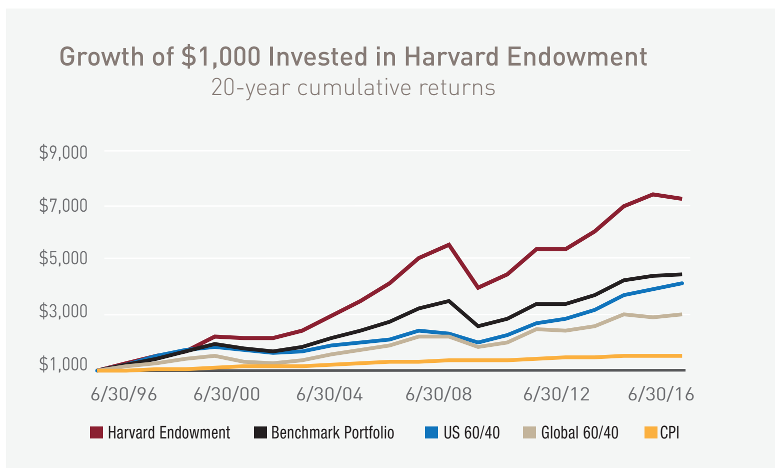
I write to share with you the endowment's investment results for fiscal year 2016, and to report on HMC's activities to reposition the portfolio and to strengthen HMC as an organization. I also provide an update on our strategic asset allocation process and conclude with comments about our outlook for the future.

For the fiscal year ended June 30, 2016, the return on the Harvard endowment was (2.0)%, resulting in a relative return to its benchmark of (300) basis points. The value of the endowment on June 30, 2016, was $35.7 billion. The low interest rate environment and market volatility of the past fiscal year presented a number of challenges to generating returns. However, we recognize that execution was also a key factor in this year's disappointing results.





The last ten years, inclusive of the global financial crisis, have been challenging for the Harvard endowment. However, over the last twenty years the endowment has returned 10.4% annualized, exceeding the average annual return on the benchmark portfolio of 7.7%. The value of $1,000 invested in the Harvard endowment has significantly outpaced both a traditional US and Global 60/40 mix of stock and bonds over the same time period.



Asset class performance was mixed in fiscal year 2016. The endowment's investment return was primarily driven by underperformance in our natural resources and public equities portfolios. We have taken several steps to improve performance in these portfolios over the long term, which I detail later in the Organizational Update.

The real estate portfolio continued its multi-year run as our highest performing asset class, driven primarily by the success of our direct investment strategy, which now comprises more than half of the overall real estate portfolio. Our internal real estate team and joint venture partners have developed a direct investment program that has delivered outstanding results since its inception in 2010.

The endowment distributed $1.7 billion to Harvard University in fiscal year 2016—contributing more than one-third of the University's total operating revenue. Since inception, HMC has distributed more than $25 billion to Harvard University, enabling industry-leading financial aid programs, groundbreaking discoveries in scientific research, and hundreds of professorships across a wide range of academic fields.

Strategic Asset Allocation Process

HMC's strategic asset allocation process seeks to identify appropriate asset class allocations that best suit the long-term risk and return objectives of the University. This framework is designed to expose the endowment to primary drivers of long-term market returns and risk premia, while ensuring proper diversification of our investment strategies. In our factor-based approach, we first select a set of macro factors and measure our asset class exposure to these factors. This analysis produces an allocation range for each asset class. With these ranges determined, HMC chooses an optimal portfolio and a corresponding target allocation for each asset class, while also taking into account liquidity considerations.

The resulting asset class target allocations form the strategic asset allocation, which aims to balance the long-term objectives of return generation, risk management, and liquidity provision. The actual asset allocation at a particular point in time may deviate from the strategic asset allocation, within the defined ranges.

Fiscal Year 2016

Asset Class	Strategic Asset Allocation
Domestic Equity	10.5%
Foreign Equity	7.0%
Emerging Market Equity	11.5%
Private Equity	20.0%
Absolute Return	14.0%
Real Estate	14.5%
Natural Resources	10.0%
Domestic Bonds	9.0%
Foreign Bonds	1.0%
Inflation-Linked Bonds	2.0%
High-Yield Bonds	0.5%
Total	**100%**

Risk and Liquidity

Risk management is an essential and integral part of the endowment's investment management process. With low interest rates across the world, many traditional liquid asset classes have experienced diminished returns, and asset managers are challenged to find high-growth/high-return assets. Our Risk team monitors the portfolio on a continuous basis to ensure that the volatility of the portfolio is within acceptable limits. Additionally, in order to provide continuous and reliable funding to the University in various market conditions, we need to manage our liquidity carefully, especially under stress scenarios, to ensure that at least 5% of the endowment can be realized in liquid form within 30 days.

Discussion of Fiscal Year 2016

Market Overview

Fiscal year 2016 was a bumpy ride for most investors. Equity markets, in particular, displayed increasing volatility with significant sell-offs in August 2015 and January 2016. However, in the last few months of the fiscal year, equities regained their footing and recovered some of their losses amid increasingly accommodative central bank policies. Over the course of the fiscal year, the Federal Reserve abandoned its path of raising interest rates after one hike in December. Chinese authorities unleashed a range of stimulative policies and central banks outside the US, particularly in Japan and Europe, expanded their asset-buying programs.

Domestic equity markets continued their recent pattern of outperforming foreign and emerging equity markets, with the S&P 500 rising 4.0% for the fiscal year. However, S&P 500 earnings declined by 4.0% during the fiscal year, largely attributable to reduced earnings in the energy sector as commodity prices dropped to multi-decade lows. With the domestic equity market near all-time highs, a further decline in earnings growth would leave it vulnerable to reduced valuation levels.

International markets had a rough start to the fiscal year, fueled by increasing concerns around slowing Chinese growth and deflation in Europe. The MSCI EAFE Index returned (9.3)% and emerging markets equities returned (12.1)%, with Europe, Japan, and China experiencing the most severe declines. On a P/E basis, emerging markets equities are as cheap relative to developed markets as they have been since the global financial crisis. However, most of the emerging markets economies face their own set of fundamental challenges, whether around economic rebalancing (China), politics (Brazil), or poor growth and nonperforming loan cycles (China, India).

The biggest market surprise of fiscal year 2016 might very well have been that foreign bonds were the best performing asset class (the benchmark was up 12.4%). Over the twelve month period, the proportion of global sovereign debt trading at negative yields increased from approximately 10% to 25%. Domestic bonds also returned an impressive 6.2%. Credit markets experienced significant volatility during the course of the fiscal year, ending the year with spreads wider relative to the beginning of the fiscal year but narrower than their February highs.

The trend for global growth seems likely to remain subdued, with both demographics and productivity improvements languishing in many developed economies and China remaining the most critical unknown. These forces have combined with new and untested market structures evolved from regulatory changes and have affected liquidity in many markets, particularly credit. With few of these factors likely to change in the near term, it appears we might be living with bursts of volatility and whipsawing markets for some time.

Portfolio Overview

Fiscal Year 2016 Performance

	Fiscal Year 2016 Return			5-Year Annualized Return
	HMC	Benchmark	Relative	Relative
Public Equity	(10.2)%	(6.1)%	(4.1)%	0.5%
Private Equity	2.6	2.2	0.4	(0.3)
Fixed Income	5.5	6.2	(0.7)	3.8
Absolute Return	(1.2)	(0.3)	(0.9)	2.2
Real Estate	13.8	9.4	4.4	3.3
Natural Resources	(10.2)	1.4	(11.6)	(2.1)
Total Endowment	**(2.0)%**	**1.0%**	**(3.0)%**	**0.5%**

Fiscal year 2016 performance was disappointing on both an absolute and relative basis. The endowment portfolio's 300 bps of underperformance relative to our benchmark was driven primarily by losses in our public equity and natural resources portfolios. Deviations from our strategic asset allocation also detracted from performance. Our real estate portfolio had material outperformance and private equity also exceeded its benchmark.

Public Equity

	Fiscal Year 2016 Return			5-Year Annualized Return
	HMC	Benchmark	Relative	Relative
Domestic Equity	(4.9)%	2.5%	(7.4)%	1.7%
Foreign Equity	(14.2)	(9.3)	(4.9)	(0.4)
Emerging Markets	(12.0)	(12.1)	0.1	0.1
Total Public Equity	**(10.2)%**	**(6.1)%**	**(4.1)%**	**0.5%**

Our public markets equity portfolio returned (10.2)%, trailing the blended public equity benchmark of (6.1)%. Developed markets underperformed with both domestic and foreign equity trailing their benchmarks significantly. In emerging markets equities, our performance was relatively flat to the benchmark. As I will detail in the Organizational Update, we have repositioned our public equity strategy to rely more heavily on external managers.

Unfortunately, a number of our domestic equity external managers underperformed for the first time in many years amid a difficult period for active management overall, particularly for value-oriented strategies. Several of our external managers also held closely correlated portfolios, particularly in underperforming healthcare stocks, further impacting the performance of the asset class. This will be a key area of focus for our team going forward.

Private Equity

	Fiscal Year 2016 Return			5-Year Annualized Return
	HMC	Benchmark	Relative	Relative
US Corporate Finance	8.3%	4.8%	3.5%	(2.0)%
Intl Corporate Finance	1.0	6.5	(5.5)	(0.9)
Venture Capital	(1.5)	(0.2)	(1.3)	6.2
Total Private Equity	**2.6%**	**2.2%**	**0.4%**	**(0.3)%**

Private equity generated modest relative outperformance for the fiscal year but performance varied by subsector. US corporate finance was the strongest performer while venture capital returns moderated after several years of very strong performance. We are actively concentrating the portfolio by scaling our commitments to a core group of top managers, and selectively adding new relationships to address gaps in the portfolio.

Fixed Income

	Fiscal Year 2016 Return			5-Year Annualized Return
	HMC	Benchmark	Relative	Relative
Domestic	6.7%	6.2%	0.5%	1.4%
Foreign	10.9	12.4	(1.5)	6.8
TIPS	1.6	4.4	(2.8)	2.2
High Yield	2.1	0.9	1.2	(0.6)
Total Fixed Income	**5.5%**	**6.2%**	**(0.7)%**	**3.8%**

Our fixed income portfolio, managed entirely internally, had mixed performance for the fiscal year. Our credit strategies suffered losses, while our relative value strategies performed well as we continued to capitalize on opportunities globally.

Absolute Return

	Fiscal Year 2016 Return			5-Year Annualized Return
	HMC	Benchmark	Relative	Relative
Total Absolute Return	**(1.2)%**	**(0.3)%**	**(0.9)%**	**2.2%**

Our absolute return portfolio was down modestly and trailed its benchmark by 90 bps for the fiscal year. Event-driven and credit-oriented strategies underperformed while systematic and uncorrelated strategies outperformed. While the hedge fund space has become more competitive over the last decade, we continue to believe that partnering with best-in-class managers will lead to attractive risk-adjusted returns in excess of our benchmarks.

Natural Resources

	Fiscal Year 2016 Return			5-Year Annualized Return
	HMC	Benchmark	Relative	Relative
Total Natural Resources	**(10.2)%**	**1.4%**	**(11.6)%**	**(2.1)%**

The macro environment for direct natural resources investments was challenging as commodity prices continued to decline for much of the fiscal year. Market transactions for timber and agricultural land in many regions were limited, impacting portfolio liquidity in the short term. The portfolio trailed its benchmark by over 1100 bps, primarily driven by unfavorable market and business conditions across two assets in South America. One asset experienced severe drought during the crop season as well as an unusually high cost of production. The valuation of the second asset declined as a result of a challenging economic and political environment that made it increasingly difficult to secure financing. As I detail in the Organizational Update, we have hired a new head of our natural resources portfolio and are optimistic we can improve performance in this asset class going forward.

Real Estate

	Fiscal Year 2016 Return			5-Year Annualized Return
	HMC	Benchmark	Relative	Relative
Total Real Estate	**13.8%**	**9.4%**	**4.4%**	**3.3%**

Our real estate portfolio encompasses direct activities and external fund investments. Over half of our real estate portfolio is now in direct investments—a strategy HMC began in 2010. The direct strategy continued to perform especially well, earning a total return in fiscal year 2016 of 20.2%. This approach also provides the benefits of enhanced transparency, control over entry and exit, better risk control, and lower overall cost structure.

Investment Objectives

In fiscal year 2015, HMC set forth three investment objectives that we believe are essential to delivering superior long-term risk-adjusted returns. These investment objectives, which measure our performance against real, relative, and peer returns, are ambitious goals set to serve the University over the long-term. As such, we will measure our performance relative to these objectives over five- and ten-year market cycles. In any given year we may not achieve each of the stated objectives, as was the case in fiscal year 2016. However, as discussed in the Organizational Update, we have taken several steps to improve performance and are confident that the endowment is well-positioned to achieve our goals over the long-term.

Compensation

In fiscal year 2016, we redesigned our compensation system to further align the interests of HMC's investment professionals with those of the University. Starting in fiscal year 2017, compensation paid to internal investment managers will tie a meaningful share of variable compensation to HMC's performance relative to our three investment objectives. The new compensation plan retains important features of the previous plan, including: the majority of total compensation is directly linked to performance relative to appropriate industry benchmarks and incentive payments are made over a multi-year period with a significant portion held back and subject to forfeiture to ensure sustained performance.

Organizational Update

The past several months have been a time of transition for HMC. After serving the organization for eight years as chief operating officer and a member of HMC's executive leadership team, it has been my pleasure to serve as interim president and CEO since May. The HMC Board of Directors has engaged David Barrett, a prominent executive search firm, to conduct the search for a CEO, following Stephen Blyth's resignation in July. We are grateful to Stephen for his many contributions during his nearly ten-year career at HMC.

In June 2016 we reduced the size of our internal equity team and refined our strategy to emphasize deeper and broader relationships with managers for whom HMC can be a partner of choice. This portfolio will be managed by a new head of absolute return and public markets funds who we expect to hire later this year. Our remaining internal equity activities in emerging and foreign markets have been combined with fixed income, credit, and commodities to form a cross-asset public markets platform.

I am pleased to report that Colin Butterfield has been appointed managing director, head of natural resources, and will join HMC in early October 2016. Colin brings significant investment leadership experience in agriculture and timber investing. He will oversee and develop HMC's natural resources investment team and continue to evolve HMC's suite of manager relationships for its direct natural resources investments. We will look to Colin to refine our natural resources investment strategy and to bring the best opportunities at scale to our portfolio.

The HMC Investment Committee formed in fiscal year 2015 has been an important forum to develop a deeper understanding of, and gain greater conviction in, investments across the portfolio. Committee members explore opportunities between asset classes, allowing constructive feedback and comparable analysis.

HMC continues to be guided by a distinguished Board of Directors, under the leadership of Paul J. Finnegan. In fiscal year 2016, Glenn H. Hutchins and Martin L. Leibowitz retired from the Board after reaching their term limits, and Robert S. Kaplan resigned upon his appointment to serve as the president and CEO of the Federal Reserve Bank of Dallas. Over the course of the fiscal year we welcomed four new Directors: Amy C. Falls, Joshua S. Friedman, Robert Jain, and Jeremy C. Stein. Ex officio member Thomas J. Hollister also joined the Board in his capacity as chief financial officer of Harvard University. The Board skillfully informs the investment debate that advances the mission of HMC and keeps all of us at HMC focused on the long-term objectives that support Harvard University.

Sustainable Investment Update

As a signatory to the United Nations-supported Principles for Responsible Investment (PRI), the Harvard endowment is required to complete the PRI's mandatory reporting framework on an annual basis. HMC filed its first reporting framework on March 31, 2016, and the Transparency Report based on that filing is available on the PRI's website: **www.unpri.org**. The report details HMC's progress toward integrating material environmental, social, and governance (ESG) risk factors into the endowment portfolio, including the establishment of responsible investment policies, procedures, and strategies; recent shareholder engagement initiatives; the integration of ESG risk factor analysis in our direct investing portfolio; and collaboration efforts with external managers to integrate material ESG risk factors into their portfolios.

We are conducting a search for a senior vice president of sustainable investing who will have responsibility for integrating material ESG risk factors into due diligence, investment analysis, monitoring, and asset management at HMC.

Looking Ahead

As we enter fiscal year 2017, the investment landscape continues to be full of uncertainty. With a backdrop of slowing growth and rich valuations, endowment returns could be muted for some time to come. Still, the endowment's liquidity position is solid, and we feel confident about the moves we have made to reposition the portfolio. We continuously evaluate how we can best allocate capital and leverage HMC's comparative advantages to maximize performance over the long term. Investing with best-in-class managers, properly allocating assets, thoughtfully structuring our portfolio, and collaborating across asset classes will be critical to our success.

HMC is fortunate to have a strong and deep leadership team, supported by a fully engaged Board of Directors, to build on the progress that has been made this year. I am honored to serve as interim president and CEO, and remain confident in the leadership and direction of the organization to support the goals of Harvard University.