



September 2011  
 Harvard Management Company Endowment Report  
 Message from the CEO

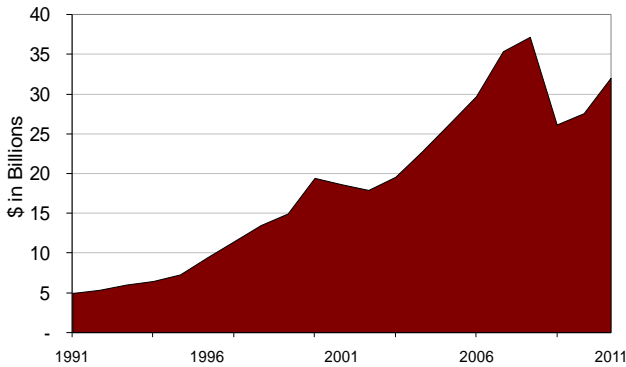
**Introduction**

The return on the Harvard endowment for the fiscal year ended June 30, 2011 was strong. The endowment portfolio earned an investment return of 21.4% and was valued at \$32 billion at the end of the fiscal year. The portfolio’s performance was 120 basis points ahead of the 20.2% return on our Policy Portfolio benchmark. Adding value over our Policy Portfolio – beating the markets – is not easily done and is not expected every year, so we are gratified by this result.

Many of the sectors in which we invest experienced robust returns during the year ended June 30, and a number of our strategies within those markets did quite well. At Harvard Management Company (“HMC”) we focus on actively managing the University’s endowment to satisfy three primary objectives: growth, liquidity and risk management. We are pleased to report that our progress in fiscal year 2011 was significant along each of these dimensions. Even with the extreme volatility that has gripped financial markets in the months since our fiscal year closed we are confident that our portfolio, while impacted by adverse markets, is well positioned to support Harvard’s mission.

We are committed to our stance as long-term investors, refining our edge and maintaining our discipline through up and down markets. While there has been some healing of the financial wounds inflicted during the crisis of 2008-2009, the portfolio and the University are still feeling the aftermath of that difficult period. The endowment value has not returned to its pre-crisis level. Given the University’s high degree of dependence on the endowment for its operations, we are ever-more convinced that strengthening the portfolio for steady growth over many years will yield the best long-term results for Harvard.

Total Value of the Endowment



**Historical Context**

Over the past two decades the average annual return on the endowment has been a robust 12.9%, beating both our Policy Portfolio benchmark and a simple 60/40 stock/bond portfolio by substantial margins.

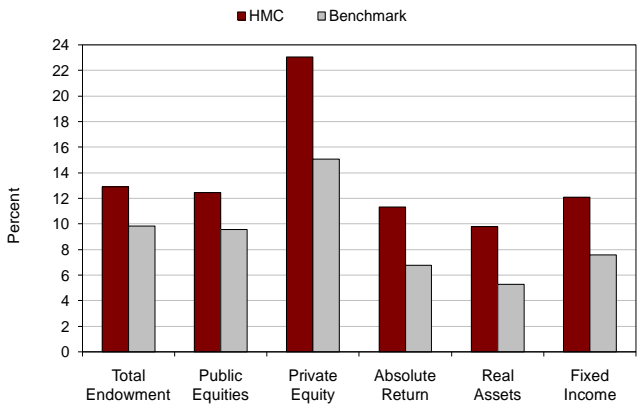
Historical Investment Return  
 Annualized for Periods Greater than One Year

	<u>Harvard</u>	<u>Policy Portfolio Benchmark</u>	<u>60/40 Stock/bond Portfolio *</u>
1 year	21.4 %	20.2 %	19.5 %
5 years	5.5	4.3	4.9
10 years	9.4	6.7	4.3
20 years	12.9	9.8	8.3

\* S&P 500 / CITI US BIG

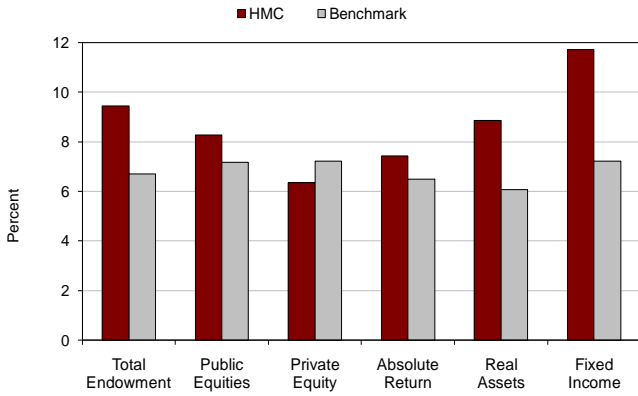
This performance is notable when we remember that there were three very difficult periods in the financial markets during these twenty years: the collapse of Long Term Capital Management in 1998, the bursting of the tech bubble in 2000-2001, and the financial crisis of 2008-2009. Despite these challenges, over this twenty year period, performance across all asset classes has been strong in both nominal and relative terms.

Annualized Twenty Year Performance by Asset Class



Over the last decade the Harvard endowment has outperformed its benchmark by 270 basis points per year, and has also outperformed a 60/40 stock/bond portfolio by 510 basis points per year – adding roughly \$15 billion of value versus what would have been earned by a more traditional portfolio.

Annualized Ten Year Performance by Asset Class



**Discussion of Fiscal Year 2011**

As a measure of the strength of the endowment’s return in fiscal year 2011, every asset class had a positive nominal return, led by an outstanding 34.6% achieved for our domestic equities portfolio (versus a benchmark of 31.9%). The public and private equity markets were generally robust over the period, although by the end of the fiscal year the long upward climb in equity market values that started in March 2009 lost momentum. During the June 2011 quarter the S&P 500 was up only 0.1%.

Our domestic equity strategies, both internal and external, were largely successful in adding value over their benchmarks. However, our overall public equities, including foreign and emerging markets, lagged the markets. Public equities in total were up 28.3%, versus our aggregate equities benchmark of 30.4% (as shown below). Emerging markets equities had a difficult time keeping up in the context of wide dispersions in returns from one country to another. Russia, for example gained 47.3% during the year, while India was up only 8%, and China and Brazil fell between these extremes. Although emerging economies broadly showed signs of cooling during the second half of the fiscal year, with negative returns in many countries during that time, our confidence in this area is still high. The potential for significant long-term returns in emerging markets is great as they continue to grow and become even more major consumers and suppliers to the rest of the world.

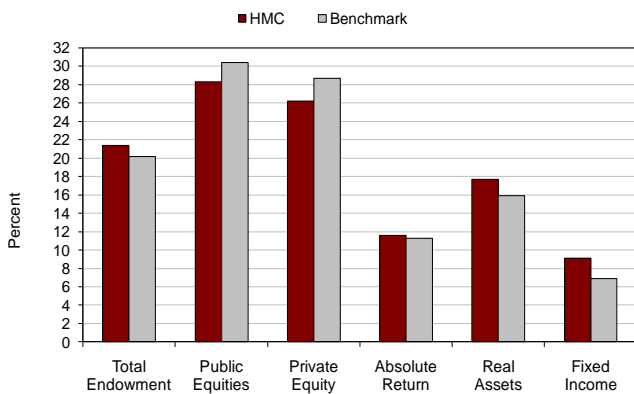
**China: Building our Investment Edge**

For the global investor, the importance of gaining insight into the growing influence of China on the world economy cannot be overstated. As a worldwide community of learning and scholarship, Harvard University has a unique view into China - its evolving capital-oriented economy, and the industrial and cultural trends generating both opportunities and risks for investors. To leverage this expertise, we hosted a “[China Day](#)” this year at HMC, bringing together guests and speakers from the US and China: academics, industry leaders, regulators and investment managers from inside and outside of Harvard. The event provided new perspectives and avenues for expanding our knowledge of, and improving our investment strategies in, this complex market. Increasingly, many HMC employees dedicate significant time on the ground in China and throughout Asia each year as part of their investment research. Our goal is to continue to develop and evolve our investment edge in China as the country and its markets gain even greater prominence and influence across the global investment landscape.



Outside of the public equity markets we also had very significant positive nominal returns in private equity (+26.2%), public commodities (+26.9%), and foreign bonds (+21.7%). Our entire fixed income team delivered excellent performance, with an average return across all market segments (US treasuries, inflation-linked bonds, and sovereign debt) of 9.1% versus 6.9% for the aggregate fixed income benchmark.

One Year Performance by Asset Class



We also had significant gains in our natural resources portfolio (reflected above under Real Assets). This portfolio, representing approximately 10% of the total endowment, is comprised of hard assets (as opposed to securities): primarily timberland, but also agricultural and other resource-bearing properties located on five continents. Our team, built over the last decade by Andy Wiltshire, our Head of External Management, is widely regarded as one of the world’s best in this sector. We started investing in timberland properties in the 1990’s and as a result we have benefited from a meaningful first mover advantage. The investment return on the natural resources portfolio last year was 18.8% and over the last ten years has been 12.8% annually.

Absolute return, our portfolio of external hedge fund managers with strategies that are less correlated to public markets, returned approximately 11.6% for the year, beating its industry benchmark by about 200 basis points. We have restructured our absolute return portfolio significantly over the last few years and are now happier with the mix of managers and strategies it contains: a variety of approaches to generating value ranging from purely opportunistic to long/short to unusual investments such as royalty streams. When public equity markets do not do as well as they did this past fiscal year, we expect this segment of our portfolio to continue to produce stable risk-adjusted returns over the economic cycle.

Our real estate portfolio had a strong double-digit return in the fiscal year (+11%), although it lagged its industry benchmark. The real estate market has many components, which generated a wide range of returns during this period and our portfolio has exposure across the spectrum. Fully-leased core properties were highly sought-after by investors, often from overseas, and prices for these properties were strong. We were able to sell some of our portfolio properties in this category at excellent values. However, while prices in core real estate were escalating rapidly, other types of real estate are recovering much more slowly following the 2008-2009 crisis. Our recently-expanded real estate team is currently reshaping the portfolio to enhance its return/risk profile. The team has established a number of promising joint venture partnerships and is making investments in inefficient pockets of the global real estate market.



### The Policy Portfolio and Long-Term Expected Returns

The Policy Portfolio – that is, the mix of asset classes that we and the HMC Board determine is best equipped to meet Harvard’s needs over the long term – provides HMC with a guide as to the actual allocation of the investment portfolio and also serves as a measuring stick against which we judge the success of our active management strategies. Each year we develop and review a long-term expected return for each of our asset classes which informs our thinking and debate around the construction of the Policy Portfolio.

In fiscal year 2011 the group within HMC responsible for arriving at the asset-class-by-asset-class expected returns was led by one of our internal equity portfolio managers, Emil Dabora, a Harvard PhD in Corporate Finance and Econometrics. Emil and an internal team of risk, analytics and investment professionals worked with portfolio managers within HMC, as well as with our Board and our Chief Risk Officer to develop a rigorous framework for projecting future capital markets returns. This cross-disciplinary work was instrumental in driving our discussion with the Board this year about the “right” target mix of assets for Harvard – and therefore the incremental evolution of our Policy Portfolio.

The evolution of the Policy Portfolio is found below:

	1995	2005	2012
Domestic Equities	38%	15%	12%
Foreign Equities	15	10	12
Emerging Markets	5	5	12
Private Equities	12	13	12
<b>Total Equity</b>	<b>70</b>	<b>43</b>	<b>48</b>
<b>Absolute Return</b>	<b>0</b>	<b>12</b>	<b>16</b>
Commodities	6	13	14
Real Estate	7	10	9
<b>Total Real Assets</b>	<b>13</b>	<b>23</b>	<b>23</b>
Domestic Bonds	15	11	4
Foreign Bonds	5	5	3
High Yield	2	5	2
Inflation-Indexed Bonds	0	6	4
<b>Total Fixed Income</b>	<b>22</b>	<b>27</b>	<b>13</b>
<b>Cash</b>	<b>-5</b>	<b>-5</b>	<b>0</b>
<b>TOTAL</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>

### Organization and Talent

This year has been an active and productive one across our organization. One of my goals as CEO of HMC is to encourage greater interchange among the talented individuals in our company, believing that we will benefit from a higher degree of cross-fertilization in our work. Through changes to our organizational structure and greater use of integrated teams, we have begun to see tangible positive results from this shift in culture. Whether we are analyzing the pluses and minuses of hard asset investments outside of the US, or commodities exposure in liquid or illiquid markets, or real estate risks in the form of financial instruments versus bricks and mortar, we are gaining deeper insights by bringing together people that work daily in public markets, private markets, traditional assets, alternatives, derivatives and US and foreign currency. While many large endowments might have access to some similar resources through external managers and consultants, none have the benefit of such a diverse team of experts who walk in the door each morning, where they can be called into an impromptu meeting or assigned to a new cross-disciplinary investigation at a moment’s notice.

On the subject of hiring, we have been fortunate during the year and have made several important additions to our team. We have a new internal group focusing on credit markets, and a recent in-house addition who is expert in trading Chinese equities. We have also added active commodities trading to our internal management capabilities. At the same time we have filled-out our real estate team and added significantly to our risk group and investment support organization.



September 2011

## Harvard Management Company Endowment Report Message from the CEO

The HMC team overall is in great shape, with a strong bench of talent across all key areas, and we are close to where we need to be for the long term. We still plan to expand our internal team, consistent with our goal of judiciously shifting assets from external managers back to our internal platform over the next several years. Given the benefits of our [hybrid model](#), including the alignment of interests, cost efficiency, and greater transparency we gain, it makes good sense for Harvard to allocate a larger proportion of the total portfolio to internal management in the coming years. Even as we add to internally managed assets, our externally managed portfolio will continue to be important for the investment activities that we either cannot or prefer not to pursue from the internal side. It also gives us tremendous geographic reach and breadth.

### HMC and Harvard Students

While many of our new hires come to us directly from the investment industry, we often look to our connection to the Harvard undergraduate and graduate programs when we add talent to our team at HMC. Over the last two years our new fulltime hires have included nine individuals with a total of twelve Harvard degrees, including undergraduate, MBA and doctorate programs. Our cadre of summer interns over the last several years has included students from Harvard College, Harvard Business School and Harvard Law School, some of whom have joined HMC fulltime after graduation.

To further our connections to the Harvard student body, our Head of Internal Management, Stephen Blyth, has developed and taught a popular spring course in Statistics “[Applied Quantitative Finance on Wall Street](#)” in each of the last two years. In addition, several other senior managers at HMC have been guest lecturers from time to time at Harvard Business School and Harvard College.

### Outlook

Since the end of the fiscal year the markets have been exceptionally volatile, driven by concern and uncertainty related to the debt ceiling debate, the fate of the euro zone, the S&P downgrade of the US Treasury securities, and indications of slowing growth in economies at home and abroad. The impact of these issues on our portfolio is unavoidable. The good news is that we have gained flexibility through the restructuring of the portfolio in recent years which allows us to take some advantage of declining valuations under the right circumstances. At the same time, our team is more global in its perspective than ever before and the critical role of risk management, within HMC and between HMC and the University, is much improved.

One thing we know for certain is that change in the investment world is inevitable. At our company we have stressed a culture of learning and continuous improvement across all parts of the organization and the portfolio. Although current markets are certainly difficult, and future returns may be uncertain, we remain focused on our mission and are confident that HMC will deliver strong long-term returns for Harvard University.

Thank you for your support.

Jane L. Mendillo  
President and Chief Executive Officer