



## Introduction

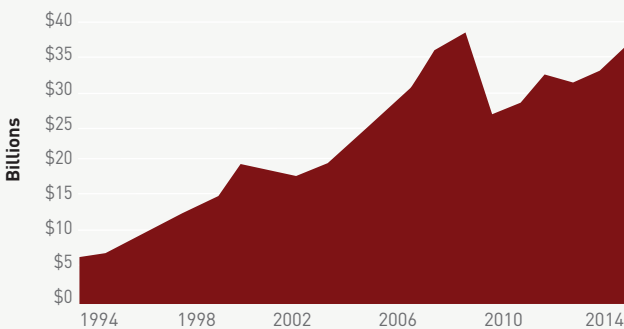
I am pleased to report that for the fiscal year ended June 30, 2014, the return on the Harvard endowment was 15.4% and the endowment was valued at \$36.4 billion. The endowment return exceeded our Policy Portfolio benchmark by 82 basis points. Over the last five years, we have consistently delivered investment returns in excess of our benchmark, resulting in a cumulative value-added above the markets of \$1.9 billion, net of all costs. Additionally, over the last five years we have distributed a total of \$11.6 billion in cash to the University, providing substantial financial support for Harvard's academic, financial aid, and research programs.

The last five years have been a period of significant recovery and repositioning for the Harvard endowment. In spite of the many difficulties experienced as a result of the financial crisis, we have delivered a five-year annualized return of 11.6%, which is consistent with the long-term returns HMC has delivered over the last 10, 20, and 40 years. Our organization and our portfolio are now well positioned to continue to deliver substantial returns and cash flow to the University for decades to come.

Investment Returns (annualized for periods greater than one year)			
	HMC	Policy Portfolio Benchmark	Relative
1-Year	15.4%	14.6%	0.8%
5-Year	11.6	10.2	1.4
10-Year	8.9	7.0	1.9
20-Year	12.3	9.4	2.9
40-Year	12.3	10.9	1.4

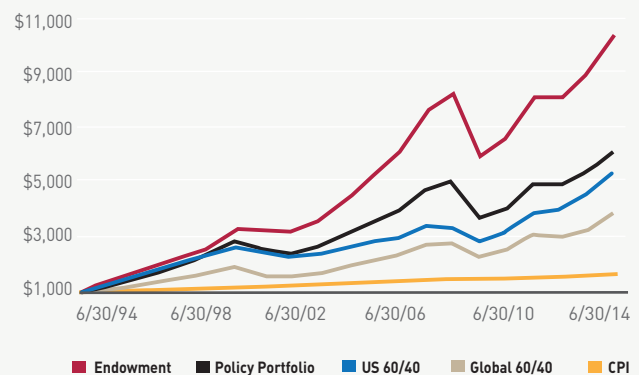
Many studies have shown that the majority of active investment managers are not successful in beating the markets in which they invest. Achieving returns that are consistently in excess of the markets—adding value above the Policy Portfolio—is not easily accomplished, although HMC has a successful long-term record on this score. Even after accounting for the impact of the financial crisis, the value of \$1,000 invested alongside the Harvard endowment in 1994 would have been more than \$10,000 at the end of fiscal year 2014.

**Total Value of the Endowment**  
(after distributions)



The steady recovery of the endowment is shown in the chart above. Over the last five years the endowment has grown in value by over \$10.3 billion.

**Growth of \$1,000 Invested in Harvard Endowment**  
20-year cumulative returns



### Policy Portfolio

The Policy Portfolio is a long-term target portfolio composed of the mix of assets that HMC and our Board judge to be the optimal fit with the University’s needs. The HMC Board and management team work together to arrive at a Policy Portfolio allocation designed to achieve three objectives: growth of the portfolio, sufficient liquidity, and appropriate risk management. The Policy Portfolio provides HMC with a guide as to the actual allocation of the investment portfolio and also serves as a measuring stick when judging the success of our active management strategies. When the endowment portfolio outperforms the Policy Portfolio, it means that active management has added value over and above the markets.

The Policy Portfolio for fiscal year 2015 is found below, along with historical Policy Portfolios. As shown in the chart, the expected long-term return for HMC’s Policy Portfolio has increased since 2008, even as leverage has decreased, as we have increased exposure to growth assets and reduced the fixed income allocation.

	Policy Portfolio 2015	Policy Portfolio 2014	Policy Portfolio 2008
Domestic Equity	11%	11%	12%
Foreign Equity	11	11	12
Emerging Markets Equity	11	11	10
Private Equity	18	16	11
<b>Total Equity</b>	<b>51</b>	<b>49</b>	<b>45</b>
Public Commodities	0	2	8
Natural Resources	11	13	9
Real Estate	12	10	9
<b>Total Real Assets</b>	<b>23</b>	<b>25</b>	<b>26</b>
<b>Absolute Return</b>	<b>16</b>	<b>15</b>	<b>18</b>
<b>Fixed Income</b>	<b>10</b>	<b>11</b>	<b>16</b>
Cash	0	0	-5
<b>Total</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>
Expected Long-Term Return	7.4	7.2	6.9

The asset class allocations in the Policy Portfolio for fiscal year 2015 were decided after in-depth analysis. A few notable topics include:

**Emerging markets.** The Harvard portfolio has significant exposure to emerging markets equity. Although these markets have underperformed developed markets equity over the last couple of years, we continue to believe that this asset class represents an attractive long-term investment opportunity for several reasons. First, emerging markets are not as crowded with investors as other world markets, resulting in opportunities to identify mispriced assets. Further, emerging markets are currently trading at low valuations versus developed markets. Finally, despite near-term challenges, many emerging countries are building their economies and their markets on attractive long-term fundamentals, including increased domestic consumption, better financial regulation, and improved physical and market logistics. Although our emerging markets exposure caused a nominal drag in recent years, we believe our portfolio’s allocation to this asset class will be a significant positive to future returns.

**Private equity.** Our Policy Portfolio allocation to private equity increased this year for two reasons: (i) we believe that targeted and judicious exposure to this asset class can lead to higher returns; and (ii) while the portfolio experienced liquidity constraints over the past five to six years, the liquidity profile of the endowment is now improved, allowing us to strategically increase our position in illiquid assets. We are aware that market conditions in private equity are somewhat heated today; therefore, we will take our time getting to this allocation. As a result, actual exposure to private equity may decrease in the near term before it increases.

**Commodities.** We have been reducing our exposure to publicly traded commodities since 2008. In prior years, this asset class served as a diversifier in our portfolio, given its negative correlation to publicly traded equity and significant market inefficiencies. In recent years, we have seen publicly traded commodities become more correlated to emerging markets equity and more populated with speculative investors. As a result, we now consider this area less valuable as a method of diversification. However, we will continue to employ our active management expertise in commodities as a pure alpha generation strategy.

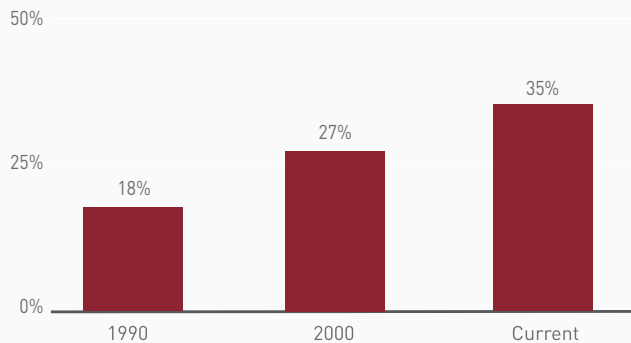
**Fixed income.** While we have reduced our exposure to this asset class steadily over the last 10 years, we maintain a Policy Portfolio allocation of 10% across all fixed income markets (US, international, and credit). Despite the currently low interest rate environment and the potential risk to the asset class from higher rates, we continue to see opportunities for active management in fixed income, as demonstrated by another year of strong performance in fiscal year 2014. We have also taken steps to partially hedge our portfolio’s interest rate risk.

### Historical Context

This past year marked an important milestone for Harvard Management Company and Harvard University—it was the 40th anniversary of the founding of HMC. Since inception, HMC has been tasked with a singular mission: to generate strong long-term returns to support what is arguably the world’s finest academic institution. In this context, we took a close look at the historical long-term cash distributions and drivers of performance.

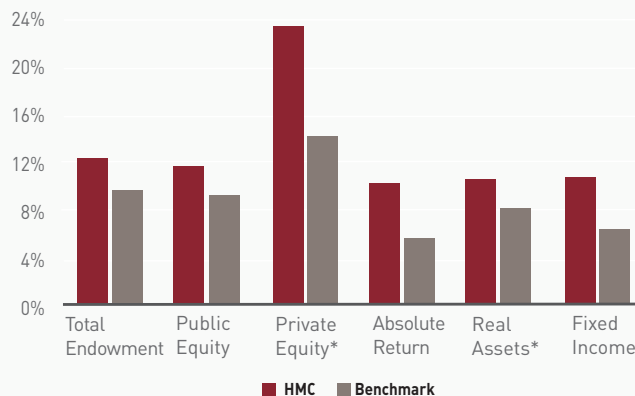
Over the last four decades, HMC has delivered \$23.2 billion in distributions to the University. The proportion of the University’s annual operating budget that is funded through endowment distributions has grown considerably over the years, now accounting for approximately 35%. This source of funding, which must be both reliable and growing, is increasingly important as the University faces decreasing federal research support and increasing economic pressures. Over the last five years alone, HMC has distributed a total of \$11.6 billion to the University, nearly 50% of the total distributions over the last forty years.

Percentage of University’s Operating Revenue Provided by Endowment

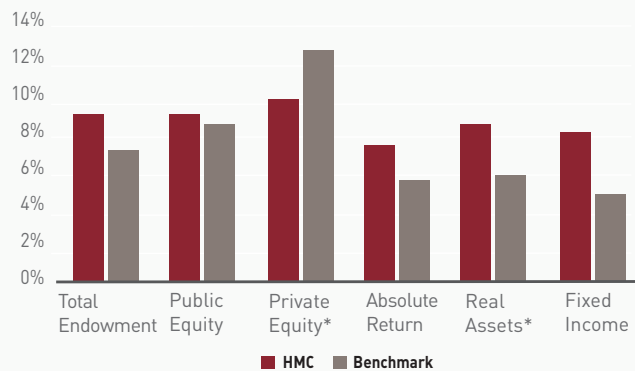


As our portfolio has evolved, the drivers of performance have evolved as well. Over the last twenty years, private equity has been a major contributor to our portfolio return, while over the last ten years the drivers of performance have been more evenly distributed.

Annualized Twenty Year Performance



Annualized Ten Year Performance



\*HMC returns and benchmarks are dollar-weighted

### HMC@40

In March of 1974, the Harvard Corporation embarked on a bold experiment, establishing a dedicated investment management organization serving a single client: Harvard University. On the occasion of this milestone we created a website to share 40 stories about HMC’s support of the University and our innovative approach to endowment management. This website, [www.hmc40.com](http://www.hmc40.com), highlights a sampling of the industry-leading financial aid programs, groundbreaking discoveries in scientific research, and world-class academic experiences that have been enabled by returns from the endowment. We also share a historical perspective of the organization from HMC’s first CEO, Walter Cabot.

## Discussion of Fiscal Year 2014

### Market Overview

The US economy continued to recover and strengthen in fiscal year 2014. Equity markets continued their upward climb as the S&P 500 rose 24.6%. Many core economic indicators such as employment and housing have improved while inflation remains benign.

International markets have been mixed, although the EAFE index returned a strong 24.2% for the year. Economic recovery in Europe trailed behind the US, but at the same time interest rates in Europe came down significantly during the fiscal year indicating that at least some of the anxiety about peripheral Europe has abated. This translated to strong foreign bond performance of nearly 8% for fiscal year 2014, versus 2% for the US Treasury market. Emerging markets were mixed during the year though continue to trade at a discount, on a price/earnings basis, to the US market. The emerging markets equity index returned 14.3% for the year.

In both stocks and bonds around the world, a common characteristic was the relatively low level of volatility across markets—the reasons for which are a topic of much study and debate. While we cannot foretell when volatility will return and how it will affect the markets in which we invest, we are fortunate to have an in-house investment team that is proven and nimble to identify alpha opportunities and to react strategically to market signals. We are confident that our portfolio, with active management employed by both internal and external managers, is well structured to ride out future corrections with greater ease and less distress than we experienced in the last crisis.

### Portfolio Overview

#### Fiscal Year 2014 Performance

	Fiscal Year 2014 Return			5-Year Annualized Return
	HMC	Benchmark	Relative	Relative
Public Equity	20.4%	21.3%	(0.9)%	0.6%
Private Equity	20.3	21.6	(1.3)	(0.5)
Fixed Income	7.7	4.2	3.5	2.9
Absolute Return	12.2	6.8	5.4	3.9
Real Assets	10.9	9.7	1.2	1.9
<b>Total Endowment</b>	<b>15.4%</b>	<b>14.6%</b>	<b>0.8%</b>	<b>1.4%</b>

In fiscal year 2014, every asset class across the portfolio achieved a positive nominal return, and the majority of asset classes outperformed their market benchmarks, although there were some places where we did not achieve positive relative performance. One factor that continues to impact our performance is a real and visible overhang from underperforming illiquid investments made during the pre-crisis era. These investments will continue to roll off over the next few years. As liquidity has improved, we have been able to invest in larger proportions in attractive new opportunities, which we are confident will lead to greater outperformance in years to come.

As in prior years, I would like to provide a few highlights regarding performance across asset classes.

### Public Equity

	Fiscal Year 2014 Return			5-Year Annualized Return
	HMC	Benchmark	Relative	Relative
Domestic Equity	25.7%	24.6%	1.1%	3.3%
Foreign Equity	20.1	24.2	(4.1)	1.1
Emerging Markets	14.3	14.3	0.0	(2.5)
<b>Total Public Equity</b>	<b>20.4%</b>	<b>21.3%</b>	<b>(0.9)%</b>	<b>0.6%</b>

Our public markets equity portfolio returned 20.4% this year, trailing the blended public equity benchmark of 21.3%. This total return, both nominal and relative, is composed of three different underlying markets, each of which had their own performance story in fiscal year 2014.

Domestic equity was the place to be in fiscal year 2014. The S&P 500 was up 24.6% for the year. Our domestic equity portfolio outpaced the US index by more than 110 basis points, a nice margin, especially given the challenge of outperforming a roaring market. Harvard's domestic equity portfolio has had a remarkable record of market-beating performance. This year marks the 20th straight year in which we have beaten the US equity market.

Developed foreign equity was also a strong asset class for the fiscal year, although our portfolio significantly lagged the market, underperforming the EAFE index by roughly 400 basis points. Over the last five years, the average relative performance of our developed foreign equity portfolio was positive.

Our emerging markets managers performed on par with the emerging markets benchmark; however, this category of equity well underperformed developed equity for the second year running.

Private Equity

	Fiscal Year 2014 Return			5-Year Annualized Return
	HMC	Benchmark	Relative	Relative
US Corporate Finance	14.1%	18.7%	{4.6}%	{2.3}%
Intl Corporate Finance	18.3	23.6	{5.3}	{1.4}
Venture Capital	32.8	22.5	10.3	4.5
<b>Total Private Equity</b>	<b>20.3%</b>	<b>21.6%</b>	<b>{1.3}%</b>	<b>{0.6}%</b>

Private equity had a strong nominal year, although our portfolio underperformed its benchmark. Private equity is one of the areas where large pre-crisis commitments and investments have continued to undercut our recent performance. For the vintage years 2004–2008, our largest commitment years, comprising 73% of the current portfolio, our funds are substantially underperforming. The performance of Harvard’s private equity portfolio excluding those outsized investments is considerably better, and we are continuing to concentrate and focus our portfolio on a strong set of relationships with top managers.

Venture capital (about one-third of our total private equity portfolio) was particularly strong in fiscal year 2014, achieving a total return of 32.8% and outperforming the venture capital benchmark by over 1,000 basis points.

Fixed Income

	Fiscal Year 2014 Return			5-Year Annualized Return
	HMC	Benchmark	Relative	Relative
Domestic	8.9%	2.0%	6.9%	2.6%
Foreign	18.0	8.0	10.0	5.6
TIPS	6.6	4.4	2.2	2.3
<b>Total Fixed Income</b>	<b>7.7%</b>	<b>4.2%</b>	<b>3.5%</b>	<b>2.9%</b>

Our fixed income portfolio, managed entirely internally, had strong outperformance in fiscal year 2014, marking five straight years of market-beating returns. Our team’s close feel for the market and significant trading experience has enabled HMC to continue to find areas of relative value in a complex global environment.

Absolute Return

	Fiscal Year 2014 Return			5-Year Annualized Return
	HMC	Benchmark	Relative	Relative
<b>Total Absolute Return*</b>	<b>12.2%</b>	<b>6.8%</b>	<b>5.4%</b>	<b>3.9%</b>

\*Includes high yield

Absolute return also marks its fifth straight year of outperformance, after sharpening our approach to the asset class following the financial crisis. Our absolute return portfolio is comprised entirely of external hedge fund managers. Unlike many investors, this portfolio does not include equity long/short managers, and we do not view this as a levered bet on equities. In fact, we view the absolute return asset class as a true diversifier relative to equity markets and we look for managers who share this view. Our portfolio—with a beta of 0.1–0.2 to the S&P 500 and a nominal return of 12.2% in fiscal year 2014—is a clear and successful expression of pure alpha generation.

Real Assets

	Fiscal Year 2014 Return			5-Year Annualized Return
	HMC	Benchmark	Relative	Relative
Real Estate	13.0%	12.0%	1.0%	{3.2}%
Natural Resources	9.0	7.5	1.5	5.7
Public Commodities	8.6	9.4	{0.8}	0.9
<b>Total Real Assets</b>	<b>10.9%</b>	<b>9.7%</b>	<b>1.2%</b>	<b>1.9%</b>

HMC’s real asset returns were consistent with our expectations and outperformed their benchmarks on average. Our natural resources performance continues to be strong, and we have a solid pipeline of interesting transactions in both timberland and agriculture. Our 10-year annualized return on the natural resources portfolio has been an impressive 11.6% versus 7.1% for the natural resources benchmark.

Our real estate portfolio encompasses direct investments, strategic fund managers (consistent with the new strategy), and legacy investments. Approximately one-third of our \$4.8 billion real estate portfolio is now in direct investments—a strategy where HMC was not active before 2010. This new direct investment strategy is working very well, earning a total return in fiscal year 2014 of 20.4%. In contrast, the legacy real estate portfolio, in run-off mode, returned only 7.8%. Below are the annualized returns of the real estate direct investment program since inception in fiscal year 2011.

	Fiscal Year 2014 Return	Annualized Performance Since Inception of Direct Investment Program
<b>Real Estate Directs</b>	<b>20.4%</b>	<b>21.8%</b>
Real Estate Strategic Funds	16.0	15.6
Real Estate Legacy	7.8	3.7
Benchmark	12.0	14.5
<b>Total Real Estate</b>	<b>13.0%</b>	<b>10.3%</b>

### Direct Investing

One advantage of our hybrid model is the ability to build teams that can create unique investment opportunities through direct investing. We have leveraged this strategy with great success in both our natural resources and real estate portfolios. Direct investing requires specialized teams that can develop sophisticated strategies unique to the markets in which they operate. Direct investing offers the benefits of enhanced transparency, better risk control, greater nimbleness, and lower overall cost structure. It also provides disciplined investors the opportunity to take more control over investment timing—entering markets when there is meaningful growth potential and exiting investments when prices are right. At the end of fiscal year 2014, about 15% of our total portfolio was in direct investments in real estate and natural resources. This is in addition to the 25% of our portfolio that is traded internally in public markets, for a total of about 40% internally managed and 60% managed by external managers.

### Organizational Update

#### *Cost of Management*

HMC recently conducted a cost of management study, which compared the total costs associated with managing the actual endowment to a portfolio of externally managed assets similar to the endowment. The objective of the analysis was to estimate the cost differential of managing the Harvard portfolio under the current HMC hybrid model versus a comparable outsourced model. The results of the study show that the Harvard endowment model has saved the University approximately \$2.0 billion over the last decade as compared to the cost of management for a completely external model.

Three key factors that contribute to these savings are: (i) lower cost structure for internally managed portfolios; (ii) lower management costs, including performance fees, for direct investing in natural resources and real estate; and (iii) lower expenses for general management activities. In addition to these cost advantages, the HMC model provides other tangible benefits such as better liquidity and flexibility, greater portfolio transparency, and better alignment between performance and compensation (through asset class benchmarks, clawbacks, and multi-year payout of incentive compensation).

#### *Staffing*

Throughout our history, HMC has had the good fortune to attract talented individuals who are passionate about supporting the goals of Harvard University. Our organization is in excellent shape, better than it has been in many years, with strong leadership and talent across the board. We recently welcomed two experienced investment leaders to our team: Rich Hall, Head of Private Equity, and Mike Ryan, Head of Public Equity. As the private equity landscape evolves and becomes ever more global, we will look to Rich and our strong Private Equity team to canvas the world in order to bring the best opportunities to the Harvard portfolio, a particular challenge given our size and the high bar that we hold for our illiquid investment partnerships. Mike Ryan will play a lead role in further developing the global strategy and long-term performance of HMC’s \$13 billion public equity portfolio. Mike will oversee and grow both our internal investment activity in equity markets and our suite of external management relationships, with the goal of outperforming the public equity markets by a meaningful margin across market cycles.

### Sustainable Investment Update

This past spring HMC further strengthened its commitment to sustainable investment by signing on to the United Nations-supported Principles for Responsible Investment (PRI), becoming the first university endowment in the United States to join the organization. We believe participating in the PRI will enhance our long-term returns by encouraging us to think and act differently with respect to the environmental, social, and governance (ESG) risks that we and all investors face.

Our partnership with the PRI has also established the foundation to support HMC's three-pronged approach to sustainable investment:

- **ESG integration.** Incorporate material ESG factors into our due diligence, investment analysis, and management processes.
- **Active ownership.** Exercise our client's voting rights as shareholders and engage with portfolio companies, as appropriate, on ESG risks.
- **Collaboration.** Collaborate with other global investors to develop and define ESG integration best practices.

We will regularly communicate our progress on these important issues to our internal and external constituents.

### Looking Ahead

The future is once again bright for HMC and the Harvard portfolio and, in that context, earlier this spring I announced my decision to step down as CEO at the end of the calendar year. I have spent 22 years at the Harvard endowment, in a wide range of roles, and I can't imagine a better way to spend a career or a more noble cause. It was six years ago this month, September 2008, that I published my first letter as CEO to our alumni community. At that time Harvard University was facing an exceptionally challenging environment as the financial crisis swept through global markets. Six years later it is a completely different story and I am very proud of what we have accomplished. We have recovered from the crisis, generated double-digit investment returns, repositioned the portfolio with adequate liquidity, helped the University to enhance its financial footing, and strengthened the HMC team and outside relationships with some of the best investment managers in the world.

There are many people to thank for this success. The team at HMC, from investments to operations, has shown strength in the face of adversity and remains intensely focused on the mission of generating strong long-term returns for Harvard. Our dedicated set of external managers and partners have been a constant source of market wisdom and new ideas. Our colleagues at the University, from the finance office to the faculty, have become true partners in our work. And I am immensely grateful for the support of the Harvard alumni and the insight of my predecessors at the helm of HMC.

The HMC Board, under Jim Rothenberg's leadership, has provided a steady hand on the tiller and encouraged us to keep looking beyond the headlines and near-term noise to concentrate on the long-term strategy and needs of the University. Most notably, President Drew Faust has been an engaged member of the HMC Board from my first day, and I am incredibly fortunate to have worked with such a strong and supportive leader throughout my tenure as CEO.

I am optimistic about the future for HMC and Harvard, and for myself, although I will miss the remarkable people I work with day in and day out. Looking forward, HMC is well-positioned to continue to deliver double-digit annual returns over the next 40 years, as we have done over the last 40-years, enabling Harvard University to pursue its inspiring and world-changing academic and research objectives. It will be exciting to watch.

All the best,



Jane L. Mendillo