Harvard Management Company Endowment Report
Message from the CEO

Introduction

The fiscal year that ended June 30, 2009 marked the close of what was very likely the most challenging period in modern times for the financial markets as well as for the Harvard portfolio. During my first year as CEO we saw extreme uncertainty in our economy and a level of volatility and dysfunction in many types of investments that went well beyond all previous experience. At Harvard Management Company ("HMC"), we actively managed the endowment through truly unprecedented market conditions over the past year while maintaining the long-term focus on investment opportunities that has served Harvard so well historically.

In previous years, HMC has reported its returns in an annual "John Harvard letter." This year, we wanted to widen the focus. In this inaugural HMC Endowment Report, we review the events of the period ended June 30, 2009, summarize the longer-term investment results of the endowment, and discuss a number of measures we have taken to realign the portfolio and to strengthen HMC as an organization. We conclude with a few comments about our outlook for the future.

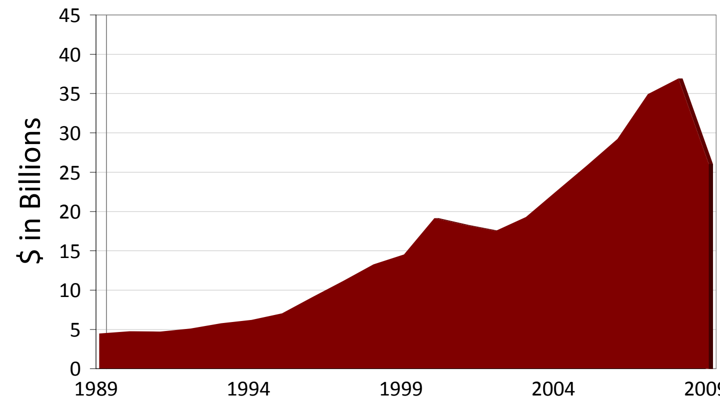
Overview of the Past Year

As of June 30, 2009, the value of Harvard's endowment was $26.0 billion. The return on the investments managed by HMC[*] during FY 2009 was -27.3% and 6.2% annualized for the last five fiscal years. This compares with the return on our Policy Portfolio benchmark of -25.2% during FY 2009, and 3.9% annualized for the last five fiscal years. Clearly, the last year was a difficult one for Harvard as it was for almost all institutional investors.

Longer-term results, discussed in more detail later, are strong, even after the broad downdrafts of the past year. This strong long-term endowment performance has been increasingly critical to the University and its operating budget.

As markets worldwide corrected sharply last summer and fall, the endowment's return was negatively impacted both absolutely and relatively. Our portfolio had its share of challenges.

Total Value of the Endowment



Historical Investment Return

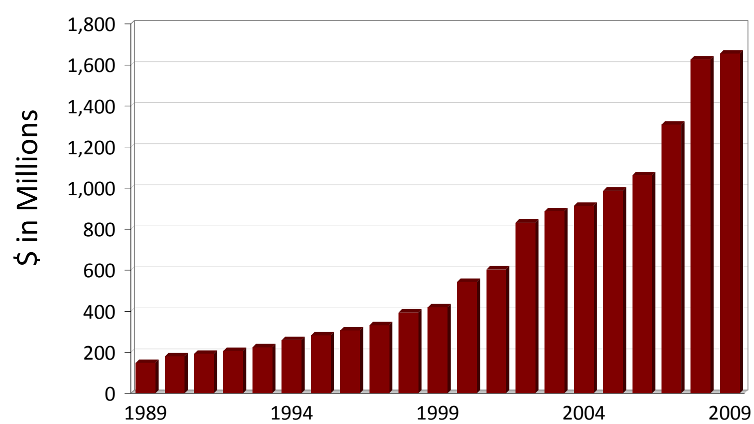
Annualized for Periods Greater than One year

	Harvard	Policy Portfolio Benchmark	60/40 Stock/Bond Portfolio *	TUCS Median **
1 year	(27.3)%	(25.2)%	(13.5)%	(18.2)%
5 years	6.2	3.9	1.0	2.5
10 years	8.9	4.5	1.4	3.2
20 years	11.7	9.5	7.8	8.0

* S&P 500/CITI US BIG

** Trust Universe Comparison Service as compiled by Wilshire Associates.

Annual Contributions to the University



[*] Endowment and related assets of $31.1 billion

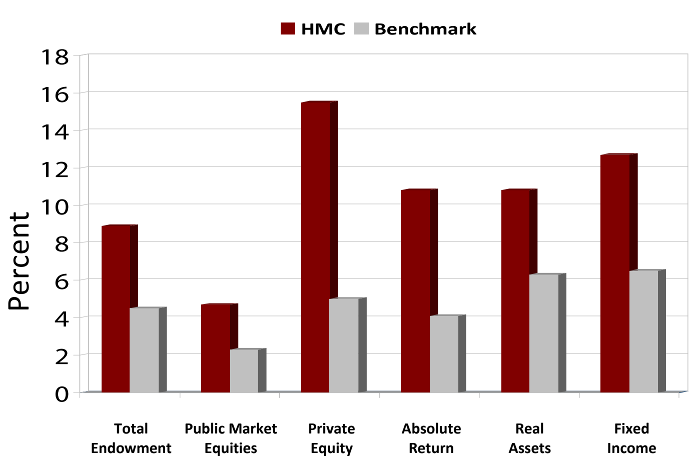
With a few notable exceptions, nearly every asset class did poorly. Our real estate portfolio, for example, suffered a loss of over 50% during the year after considering all final marks through June 30, 2009. While diversification has been a mainstay and a driver of the portfolio's return over the long-term, the benefits of diversification did not bear out through the rapidly evolving and widespread events that unfolded in FY 2009.

Fiscal Year 2009 Performance

	HMC	Benchmark	Relative
Public Market Equities	(28.3)%	(28.5)%	0.2%
Private Equity	(31.6)	(23.9)	(7.7)
Absolute Return	(18.6)	(13.2)	(5.4)
Real Assets	(37.7)	(38.5)	0.8
Fixed Income	(4.1)	(3.4)	(0.7)
Total Endowment	(27.3)	(25.2)	(2.1)

With perfect hindsight we and most other investors would have started this year in a more liquid position and with less exposure to some of the alternative asset categories that were hardest hit during FY 2009. It is important to note, however, that our portfolio has benefited greatly from our asset allocation over the long-term, which has included substantial exposure to less conventional asset classes. Private equity, for example, has earned an average of 15.5% per year for the Harvard portfolio for the last ten years even after a 32% correction in FY 2009. Our natural resources portfolio, a more recent addition, has returned 13.0% per year for the last ten years. It would be a mistake to categorically avoid these types of investments because they are less liquid. But the balance of liquid and illiquid investments within the portfolio needs to remain in the forefront of our portfolio strategy.

Annualized Ten Year Performance by Asset Class



We are never pleased with negative results either relative or absolute. However, HMC's active management during FY 2009, involving every area of the company and every part of the portfolio, helped control the damage against the headwinds we faced. Some specifics include:

- Enhanced comprehensive management across investment platforms instituted through the newly-created positions of Head of Internal Management and Head of External Management;
- Stronger operations management spearheaded by the newly-created position of Chief Operating Officer;
- Creative approaches to managing some of our illiquid exposures including early exploration of private equity secondary markets;
- Quick reactions on the part of our internal portfolio managers to both changing market conditions and the portfolio's liquidity needs.

Even in a year like this one, where virtually every asset class behaved in ways that were highly correlated, some of our individual strategies performed well:

- HMC's international fixed income team had an extraordinary year, outperforming its benchmark by over 900 basis points in FY 2009 (and achieving average outperformance of nearly 400 basis points over the last three fiscal years);
- Our internal emerging markets team outperformed its market by a meaningful margin (370 basis points) in FY 2009, amidst a sharply negative and rapidly evolving market;
- The natural resources portfolio was nearly flat in an environment of negative returns for virtually all other growth assets, confirming the diversification benefit of this category of investments even in turbulent markets;
- The overall portfolio performance was buffered by positive returns in a category of trades employed as top-down portfolio hedges.

Active management was essential throughout this period. We worked decisively to make changes to our asset allocation and to increase our flexibility early in the fiscal year. Once the ship was steadied, the team adjusted its focus to incorporate incremental market exposure and active investments within the portfolio over the last few months. We never lost sight of our focus on our long-term goal to seek substantial growth in endowment assets while managing investment risk on behalf of the University. We are acutely aware that the investment portfolio must support current University operations and maintain the purchasing power of the endowment over time.

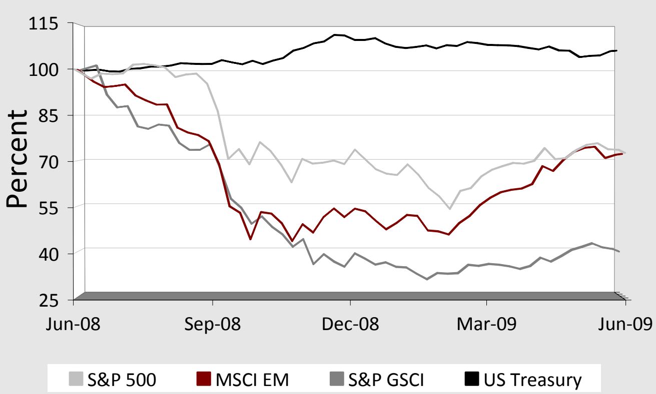
Fiscal Year 2009 Market Context

The severe market corrections of last year were a continuation and acceleration of market changes driven by the deleveraging and “derisking” across the financial system that began in 2008. Leading up to 2008, there was too much liquidity in the system – this had become a common refrain, but one that did not have a clear solution or endpoint. This excess liquidity pushed asset prices higher, and the risk premium (the difference between the value of risky and non-risky assets) lower resulting in an increasingly less sustainable situation in world markets. When a tipping point was finally reached in mid-2008, all investors were forced to react with many finding the need to sell investments quickly in order to raise cash and decrease exposure. This caused a further downward spiral in the prices of all risk assets.

Rumors of major financial institutions on the brink of collapse became reality when Lehman Brothers declared bankruptcy in mid-September 2008. As other financial institutions looked to be in peril, credit markets virtually froze and equity markets dropped dramatically across the globe. Even some major money market funds were impacted as the assets held in their portfolios were revealed to be of questionable quality.

Central banks, most notably the US Federal Reserve, stepped in quickly and aggressively. By the end of calendar 2008, the worldwide financial system seemed to be moving away from the brink of collapse, but still underlying world economies were showing signs of serious weakness. All of this led to extremely volatile conditions in virtually all markets which for the most part moved together.

Fiscal Year 2009 Index Returns



The Policy Portfolio and Relative Performance

The underlying framework for our investment activity is the Policy Portfolio, a concept that has been employed by HMC for many years. The Policy Portfolio represents our best thinking about the optimal long-term mix for Harvard’s endowment assets.

Evolution of the Policy Portfolio

The Policy Portfolio is a theoretical portfolio allocated among asset classes in a mix that is judged to be most appropriate for the University from both the perspective of potential return and risk. The HMC Board and management team create the Policy Portfolio and review it for continued fit with the University’s risk profile and our projections of long-term market returns, volatility and correlations. The Policy Portfolio provides us with a guide as to the actual allocation in the investment portfolio and also serves as a measuring stick against which we judge the success of our active investment management activities. As in any measure of investment performance, long-term results relative to the Policy Portfolio are most meaningful.

	Fiscal Year		
	1995	**2005**	**2010**
Domestic Equities	38%	15%	11%
Foreign Equities	15	10	11
Emerging Markets	5	5	11
Private Equities	12	13	13
Total Equity	**70**	**43**	**46**
Absolute Return	**0**	**12**	**16**
Commodities	6	13	14
Real Estate	7	10	9
Total Real Assets	**13**	**23**	**23**
Domestic Bonds	15	11	4
Foreign Bonds	5	5	2
High Yield	2	5	2
Inflation-Indexed Bonds	0	6	5
Total Fixed Income	**22**	**27**	**13**
Cash	**-5**	**-5**	**2**
TOTAL	**100%**	**100%**	**100%**

HMC’s active management of the investment portfolio relative to the Policy Portfolio has added an average of 4.4% per year to our returns over the last 10 years. During FY 2009 the investment portfolio underperformed the Policy Portfolio by 2.1%. Our underperformance relative to the Policy Portfolio in part stemmed from the fact that our portfolio entered the crisis with some complicating factors including:

- Aggressive commitments to illiquid asset classes;
- Within liquid asset classes, a larger proportion of strategies with long holding periods;
- A lack of ready liquidity in the portfolio to meet our obligations along with the needs of the University.

Both our internally and externally managed portfolios suffered from our overall lack of ready access to sufficient liquidity going into the financial crisis. For example, our internally managed domestic fixed income portfolio carried exposure to some of the structured credit securities that were most impacted as the market imploded. A subset of our external hedge fund managers, while experiencing their own performance problems, changed their investors' ability to redeem capital, ostensibly to protect their funds' remaining assets. We have made changes to both of these areas and other aspects of the portfolio to increase the flexibility and control we have in managing our funds while maintaining attractive return expectations.

It would be unrealistic to expect to beat the Policy Portfolio each and every year. However over the last ten years HMC has added $13 billion of value over the return of the Policy Portfolio and $18 billion of value over what would have been earned by a simple 60/40 stock/bond portfolio.

Strategic Reorientation

Harvard's endowment remains a core strength of the University, supporting the outstanding teaching and research that is central to Harvard's mission. Even after the decline suffered this past year, Harvard's endowment is significantly larger than that of any other university's and has demonstrated long-term performance superior to what would have been achieved had HMC pursued a more conservative investment strategy over the longer term.

We remain committed to the basic principle of managing and measuring ourselves against a Policy Portfolio benchmark focused on long-term returns and appropriate risk management. Managing the Harvard portfolio through the unprecedented market turmoil of the last twelve months has been challenging, but it also has provided us with an opportunity to begin to position HMC and the investment portfolio in new ways.

Importantly, we have taken action to increase flexibility, reduce leverage and position ourselves to explore the most attractive investment themes that we foresee emerging from the crisis we have experienced. With increased market liquidity, we rebalanced the portfolio productively towards undervalued assets. We have decreased our uncalled capital commitments by roughly $3 billion. We have increased the depth and breadth of talent in our investment team. We have begun reorienting our strategy and our organization to better fit with what we believe will be a rich and complex opportunity set in the future.

Past changes to the Policy Portfolio generally have been incremental. We are now in the process of rethinking certain aspects of the model to better suit current realities and lessons learned. Elements of the re-engineered Policy Portfolio may include:

- Fewer distinctions among the finely tuned asset classes to encourage greater collaboration among our teams in exploring investment themes;
- Greater concentration in areas where HMC has unique competitive strengths such as fixed income and real assets;
- Rigorous reassessment of the fit between the endowment's risk profile and the University's needs.

We expect these adjustments to our investment approach and strategy to maximize our effectiveness as active managers and to yield results over time that are well suited to the University's needs and risk parameters.

Organization and Structure

This has also been a year of change for HMC. In July 2008, I returned to HMC as CEO. Before rejoining HMC, I served as Chief Investment Officer at Wellesley College for six years. Prior to that experience, I was a senior member of the investment team at HMC for 15 years (1987 – 2002) starting my tenure as a member of the internal management team in public equities and ending as the portfolio manager in charge of all of the endowment's externally managed assets. My appreciation for the importance of HMC's mission and the rigor and excellence with which it must be pursued is deeply ingrained.

While we have made many changes in recent times, we continue to employ a "hybrid model" – a unique approach to endowment management. We use a mix of internal and external investment management teams that focus on specific investment areas. We believe this gives us the best of both worlds – top-quality investment management by our internal team and access to cutting edge capability from specialized teams around the world through our externally managed portfolio. While some parts of the portfolio, like private equity, are better suited for external management, and others, like parts of the publicly traded markets, lend themselves more naturally to internal strategies, we are not compelled to manage internally or externally in any particular proportion. Rather, we will use the mix of internal and external managers that best represents our conviction regarding opportunities and gives us access to the best possible strategies.

The benefits of the hybrid model are both broad and deep:

- Harvard's partnerships with investment management teams around the world provide diversification, insight, and perspective that goes beyond what could possibly be achieved through our relatively small team in Boston;
- Our internal investment management team, currently responsible for investing approximately a third of the portfolio, is our eyes and ears on the markets - constantly attuned and responsive to changing conditions, and frequently ahead of the curve in recognizing market inefficiencies and ways that we might profit from them;
- In addition to this close feel for the markets, our internal management approach gives us increased control, total transparency and greater nimbleness in the face of changing market conditions or University needs. Finally, our internal team is extraordinarily cost effective – with total expenses equal to a fraction of the costs of employing outside managers for similar asset pools with similar results.

For all of these reasons, while we do not have a specific target for internal or external management as a proportion of the total portfolio, we are looking to increase the share of our internally managed assets under the right conditions.

Over the last year the management team and investment support structure has been strengthened substantially including the addition of a Chief Operating Officer, Bob Ettl. Bob joined HMC in October with extensive experience most recently at Allianz/PIMCO. Bob has significantly redesigned and upgraded the investment support organization of the company and has added considerable bench strength including a new CFO, Kevin Shannon, and new Chief Technology Officer, Michael Maffattone.

In further positioning HMC as an organization driven to uncover and integrate the highest quality investment opportunities across traditional asset classes, the individual investment teams were aggregated this year under two of our senior investment professionals. As the new Head of Internal Management, Stephen Blyth oversees the investment portfolios and strategies of the public equity, fixed income and foreign currency specialists investing directly for Harvard.

Compensation at HMC

The investment management team at HMC is compensated in a way that achieves exceptionally strong alignment of interest between the manager and the University. For each asset class a benchmark is established that reflects the return that can be achieved by a passive investor (e.g., the S&P 500 is the benchmark for a large cap equity manager). When a manager outperforms their market benchmark, they earn a performance bonus which is based on the dollars of value added to the endowment portfolio over and above the benchmark. It is important to note that a sizable portion of this earned bonus is held back against the risk of possible underperformance by the manager in subsequent years. This approach has the effect of focusing the manager on sustained outperformance over multi-year periods and guards against rewarding outperformance gained through inappropriate risk-taking. As a result of this system, last year a substantial number of portfolio managers at HMC had portions of their bonuses earned in prior years "clawed back" into the endowment. A smaller group of managers – those who outperformed their markets in FY 2009 – retained their past bonuses while earning additional performance compensation this year.

Andy Wiltshire, our new Head of External Management manages the groups making investments utilizing outside managers or partners in areas such as private equity, real estate, natural resources and marketable securities.

With the management team substantially in place, we implemented a restructuring in February to better align our company structure with investment opportunities going forward. We are now focused on strengthening staff and adding world-class talent to supplement our core areas of expertise. As a result, we recently made several additions to our investment teams, including Michele Toscani in fixed income/Asian markets, Emil Dabora and Mark McKenna in equity arbitrage, Dan Cummings in real estate and John Barker in externally managed funds. We will continue to seek out exceptional individuals with unique investment insights who will drive value for the portfolio.

Risk Management

Risk management is a critical component of successful portfolio management and must be integrated into the fabric of our investment strategy in order to protect the assets we are managing. HMC management and the HMC Board devote substantial staff, time and attention to the complexities that relate to the risk inherent in our portfolio.

There are multiple forms of risk in an investment portfolio – market risk, leverage, counterparty risk, illiquidity, the risk of stronger-than-expected correlation and the risk of less-than-complete transparency. The past year has offered up many lessons regarding the means to perceive, measure and control risk in a highly diversified portfolio such as Harvard's. Overall, our risk management was adequate. We did not suffer the extreme volatility of many of the markets in which we participate. We did not find we were in partnership with fraudulent third party management. Even with the bankruptcy of Lehman Brothers and other major credit events, we had negligible losses related to counterparty risk. We kept the ship righted in a real-life correction that exceeded our most extreme theoretical stress tests.

All of this having been said, we can do and are doing more to manage the risks we face, given the lessons of the past year. The most important of these lessons is that the risk tolerance of the University continues to be a critical factor in the decisions regarding asset allocation, flexibility and accessibility of the investment strategies we choose.

The Road Ahead

As we enter the new fiscal year, many questions remain about the underlying health of the world economies albeit there have been recent encouraging signs of slower deterioration and possible growth in profits ahead. Massive government stimulus has provided some optimism in the markets, but spirited debates continue about the dangers of specific sectors including the financial institutions upon which so many markets and consumers depend.

We continue to debate the dueling threats of inflation and deflation, and can make cases for both. In any event, we expect a prolonged period of instability and slower growth in some markets. For the economy overall, we do not anticipate a quick return to the rapid, sustained growth experienced in recent times.

Even so, there will be many opportunities to create value through prudent and creative investment strategies in the coming months and years. In times of uncertainty active management is increasingly important. We expect to find some of our most interesting investment opportunities outside of and across traditional asset class boundaries and are pursuing investments consistent with this theme today. While we will be guided by our Policy Portfolio, we will continue to explore with rigor creative new opportunities whether contemplated by the Policy or not (such as our timberland investments were when they were first made). In addition, we will maintain a continuous measure of accessible liquidity in the portfolio to preserve both our ability to capture unforeseen opportunities and to support the needs of the University.

In navigating the past year's storm, we have developed greater financial flexibility, strengthened our investment team, sharpened our focus and positioned both HMC and the Harvard portfolio to be robust, steady and importantly, poised to benefit from growth in the world's economies. We have reset the building blocks for a solid, innovative and sustainable investment strategy. Given all of this, we have ample cause for optimism in the next few years particularly given the following:

- Our liquidity is much improved and increasingly under our control;
- Our HMC team is stronger and the opportunity to engage new talent is greater than it has been in years;
- We are alert to new and different ways of looking at what have become the traditional models.

While we are implementing a variety of shifts to our portfolio strategy and are confident that these shifts will bear fruit over time, it is important to be realistic about near-term returns and about our expectations for several years to come. The impact of the events of 2008-2009 will not be reversed overnight. For Harvard, as for almost every major investor, regaining the market value lost as a result of the recent global economic crisis will take time.

When I returned to HMC as CEO a year ago, few could have predicted the extent of the external market turmoil of the past year. As we enter a new fiscal year, I continue to be inspired by the mission of this great university and the role of HMC in supporting that mission. My respect and admiration for my colleagues continues to grow. I am confident that the portfolio is well positioned, from both a risk and return standpoint, to support the University and its operations into the future.

Jane Mendillo

Jane L. Mendillo
President & Chief Executive Officer