



HARVARD MANAGEMENT COMPANY, INC.

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BOSTON, MA 02210-2203

Mr. John Harvard
Harvard Yard
Cambridge, MA 02138

August 21, 2007

Dear John:

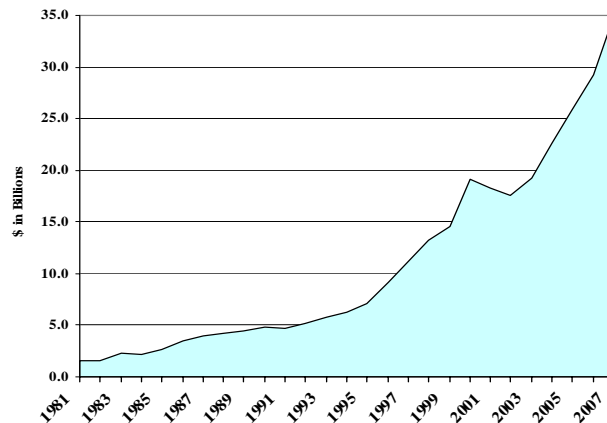
In this sixteenth annual letter from the Harvard Management Company (HMC) to the friends of Harvard, we would like to update you on three main topics: the endowment results for the fiscal year that just ended, progress made in rebuilding our institution during this period of transition, and some of the challenges we face looking forward. In addition, we would like to inform you on the endowment's performance last month against the backdrop of general market disruptions and the failure of one of our external managers. Finally, and based on feedback we received from members of the Harvard community, we would like to share with you upcoming changes in the manner in which we provide you information on HMC and its activities.

Overview

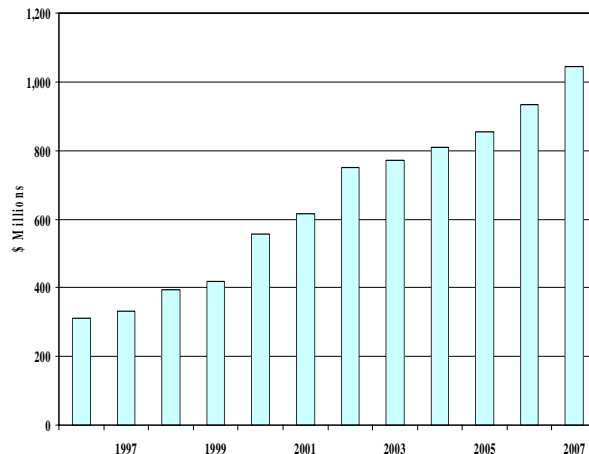
The endowment registered another year of strong absolute and relative performance. Total investment return for the 2007 fiscal year (July 2006 – June 2007) amounted to 23.0%, net of all expenses and fees. In delivering one of its strongest years, HMC solidly out-performed its three distinct institutional benchmarks pertaining to both absolute and relative returns.

Reflecting the strong investment results, and after taking into account annual distributions to the University and the receipt of new gifts, the value of the endowment grew from \$29.2 billion as of end-June 2006 to \$34.9 billion as of end-June 2007 (Exhibit 1); the total value of the "General Investment Account" (GIA), which constitutes the pooled assets managed by HMC that include the endowment and related accounts, grew from \$33.7 billion to \$41.0 billion. As a result, University recipients will experience in FY08 another increase in endowment distributions to

**Total Value of the Endowment
1981-2007** **Exhibit 1**



**Annual Contributions to the University's Operating Revenue
1996-2007** **Exhibit 2**



support teaching, research and student aid. In FY07, such distributions amounted to \$1.1 billion, or more than three times the level of ten years ago (Exhibit 2).

The Market Context

Three specific factors generally boosted financial markets in FY07: (i) high global growth, led by emerging economies that also continued to accumulate international reserves and invested them in a manner that contained interest rates, volatility, and credit risk spreads; (ii) robust mergers and acquisitions activity facilitated by large flows to private equity and favorable financing conditions; and (iii) investor confidence in policy makers' ability to sustain financial stability in the context of low inflation. This offset the impact of a slowing US economy and pockets of credit market stress (including the US sub-prime segment).

These factors were particularly supportive of equity markets, many of which reached new or near record levels in FY07. Emerging markets had a particularly strong year, benefiting also from increased investor interest. Credit spreads remained tight, notwithstanding large debt issuance associated with the intensification of buyout activities.

Global government bond markets experienced a more challenging year. Investor expectations that the Federal Reserve would cut interest rates were countered by mounting evidence that the global economy could "de-couple" from the US cycle. Indeed, several other central banks hiked rates.

Growing investor interest continued to boost the less liquid asset classes. This is particularly true for two asset classes where HMC has been historically under-allocated, especially relative to university peers. Private equity in general—and leveraged buy-out funds in particular—benefited from the combination of broadening investor interest, favorable financing, and a cash-rich corporate sector. Real estate also registered strong gains notwithstanding pressures on parts of the US residential segment. Meanwhile, commodities were held back by a mid-year softening of oil prices which was subsequently reversed.

While generally supportive conditions characterized global financial markets in FY07, there were notable episodes of sharp and sudden technical disruptions that shed light on elements of underlying market fragility. For example:

- In late February/early March 2007, concerns about the sustainability of China's rally led to significant global market instability. The valuation corrections were notable in their swiftness and coverage, including a high degree of correlation among different assets, geographies, and segments.
- The last two weeks of June 2007 witnessed another bout of risk aversion triggered by renewed concerns about US housing in general, and sub-prime and various structured products in particular.

This phenomenon of generally benign market conditions interspersed with periods of intense instability raises interesting portfolio management considerations—an issue to which we will return below.

Performance of the Endowment

Consistent with global developments, the main drivers of the endowment's absolute return in *fiscal year ended June 2007* included our emerging market, international, and domestic equity exposures (through both public and private vehicles). Emerging market bonds also did well, benefiting from both capital appreciation and carry. The absolute return/special opportunities and real estate categories had a good twelve months, while also offering some diversification during periods of market volatility.

Notwithstanding the fact that HMC is still in a transition phase, the FY07 investment return is consistent with Harvard's history of superior investment performance. Indeed, as illustrated in Exhibits 3 and 4, the FY07 return of 23.0% exceeds various historical averages. Relative to the major US indices, the endowment out-paced the 20.6% registered by the S&P in FY07 and the 6.1% registered by the Lehman Aggregate (which is a broad measure of the bond market).

Within the overall investment return, HMC's efforts to add value contributed 580 basis points, again above the historical averages. This translates into \$1.7 billion of additional value for the endowment (and \$1.9 billion for the GIA as a whole). In the process, HMC maintained the record of delivering long-term value added across the eleven (non-cash) asset classes we invest in (Exhibit 5).

Traditionally we have used the TUCS universe (Trust Universe Comparison Service) as the metric for peer comparison. On the basis of this measure, which incorporates available data on 151 large institutional investors, the endowment's performance exceeded the median return of 17.7%, as well as the 20.9% that marks the top 5 percentile for this sample. We do not have sufficient information at this point on the performance of other universities as most are yet to report their results.

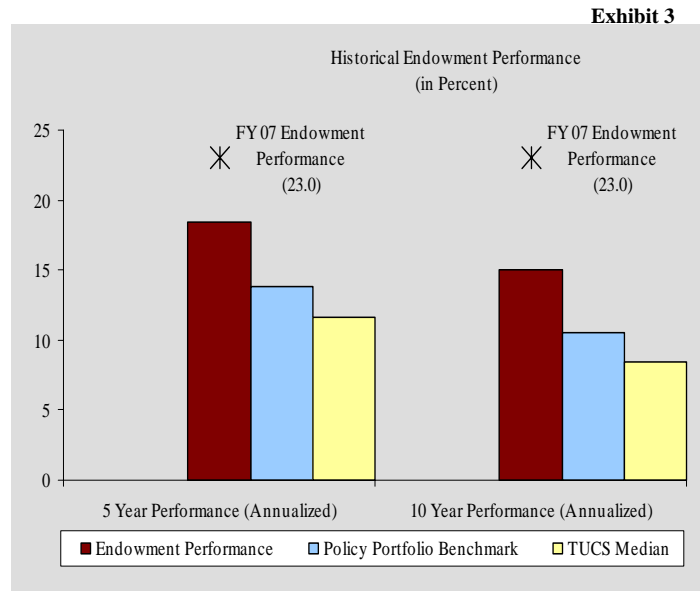


Exhibit 4

Average Annualized Percentage Returns
for Periods Ended June 30, 2007

	Policy		
	Total Return	Portfolio Benchmark	Value Added
FY07	23.0	17.2	5.8
5 Years	18.4	13.8	4.7
10 Years	15.0	10.5	4.5
15 Years	16.2	12.2	4.0
20 Years	14.0	11.5	2.5
25 Years	15.7	13.9	1.8
30 Years	14.3	12.6	1.7
Since Inception	13.3	11.9	1.4

HMC's value added efforts benefited from bottom-up internal and external portfolio management capabilities, as well as top-down adjustments in overall positioning. Specifically, the endowment's value was enhanced by:

- The out-performance of our internal portfolio management group,
- The strong results delivered by some long-standing external managers,
- Returns generated by recent additions to our stable of external managers, and
- Asset allocation adjustments driven by intra-year risk mitigation considerations.

We are also excited about some of the new approaches that HMC portfolio managers pursued in FY07. While the specific opportunities are relatively small at this point—in absolute terms and relative to more traditional strategies—they have the ability and potential to grow over time. They involve looking at under-exploited market segments that speak directly to our secular themes (see below), helping to develop new investment vehicles drawing on modern portfolio tools and techniques, and seeking incremental value through a deeper and broader set of institutional relationships.

Exhibit 5

Some of you have asked us how the endowment fared during the market disruptions of *July 2007*, including the impact of the failure of Sowood Capital Management, an external manager formed by a team that spun off from HMC in 2004. Based on the information we have received so far, on a standalone basis the Sowood losses would translate into a decline of about 1% in the endowment relative to the end-June valuation.

	Asset Class Performance						
	(in Percent)						
	5 Year Performance (Annualized)			10 Year Performance (Annualized)			
	HMC	Benchmark	Relative	HMC	Benchmark	Relative	
Equities							
Domestic Equities	13.1	11.3	1.9	11.6	8.4	3.2	
Foreign Equities	19.8	18.5	1.3	11.3	8.4	2.9	
Emerging Markets	32.0	30.9	1.1	14.6	13.7	0.9	
Private Equities	20.0	16.4	3.6	30.6	14.0	16.6	
Fixed Income							
Domestic Bonds	14.5	5.2	9.3	13.7	6.8	6.9	
Foreign Bonds	16.9	6.8	10.1	13.3	4.9	8.4	
High-Yield	18.1	13.8	4.3	9.8	4.9	4.9	
Real Assets							
Commodities	17.4	9.2	8.2	12.4	6.2	6.1	
Real Estate	21.1	15.7	5.4	17.3	15.1	2.2	
Inflation-indexed Bonds	6.2	6.3	(0.0)	N/A	N/A		
Absolute Return and Special Situations	15.0	11.0	4.0	N/A	N/A		
Total	18.4	13.8	*	4.7	15.0	10.5	*
Median Fund		11.6	**		8.4	**	

* Policy Portfolio

** Large fund mean and median performance as measured by Trust Universe Comparison Service (TUCS)

The Sowood-related losses, as well as the more general impact of financial market dislocations, were offset by gains on account of the overall positioning of the portfolio, including a number of market hedges implemented in the context of our overall risk management process. The endowment also benefited from a high degree of diversification among internal and external portfolio managers and strategies. As a result, the initial estimate for the month of July points to an aggregate gain in value for the endowment of 0.4%. (As a comparison, the S&P fell 3.1% during that month while the Lehman Aggregate rose 0.8%).

The Institutional Context

Beyond the level and diversified nature of the endowment's return, FY07 saw important institutional changes as we complete the transition phase at HMC. Efforts in this area are aimed at establishing conditions for sustaining superior investment returns over time, including the development of deep organizational and institutional roots.

We would note five specific initiatives that, in the context of ongoing changes in the global financial landscape, target the appropriate balance between continuity and change:

- During the course of the year, we completed the process of reconstructing our internal portfolio management platform. It now consists of teams covering five market segments: advanced country equities, emerging market equities, domestic fixed income, international fixed income, and foreign exchange. In the process, we hired top talent from the industry that complements our existing staff.
- We restructured the allocations to external managers within the confines of various lock ups. In addition to emphasizing bottom-up manager-related issues, this process was influenced by the secular themes mentioned below.
- Risk management activities benefited from updates in analytics, scenario formulation, guidelines, monitoring mechanisms, and the scope of risk mitigating instruments. Particular emphasis was placed on potential cross-asset class correlations and market contagion.
- Progress in these areas facilitated ongoing efforts to retool key support functions. While these are less visible to the outside world, they are nonetheless important for the sustainability of superior, risk-adjusted investment returns.
- Finally, further steps were taken to enhance HMC's corporate governance. The Board Committee structure was expanded and strengthened, and the self-evaluation procedures were revised.

Communicating with the Harvard Community

Our interactions with members of the Harvard community suggest that it is time to revisit our approach to written communication which traditionally involved three elements: the John Harvard letter; the subsequent coverage in the University's Financial Report; and the December press release on HMC's compensation.

Many of you have told us that, while cognizant of the need to appropriately limit what we disclose about investment strategies and vehicles, we should nonetheless be more transparent about HMC's structure, activities, and governance. We agree. Accordingly, we will be launching in mid September 2007 a web site (www.hmc.harvard.edu). This will be followed in October 2008 with the introduction of HMC's Annual Report which, together with a timely press release on our annual investment results, will replace the John Harvard letter and part of the coverage in the University's Financial Report. We will continue to release in December the information on compensation.

We believe that these changes will enhance the flow of timely information to the Harvard Community and elicit valuable feedback, without adversely impacting HMC's competitive position in the investment industry.

The Road Ahead

Exhibit 6 details changes to our neutral asset allocation for the period ahead. In addition to the usual risk/return optimization methodologies, the changes reflect our secular themes which include (a) the re-alignment in key components of global growth, (b) the structural weakening of global dis-inflationary pressures, (c) the gradual redeployment of windfall reserve gains by emerging economies, (d) the institutionalization of alternatives, and (e) the broader application of risk transfer technology to balance sheets within and beyond the banking system.

Exhibit 6

Historical Evolution of the Asset Mix/Policy Portfolio						
	<u>1980</u>	<u>1991</u>	<u>1996</u>	<u>2000</u>	<u>2007</u>	<u>2008</u>
Equities						
Domestic Equities	66	40	36	22	12	12
Foreign Equities	-	18	15	15	11	12
Emerging Markets	-	-	9	9	8	10
Private Equities	-	12	15	15	13	11
Total Equities	66	70	75	61	44	45
Fixed Income						
Domestic Bonds	27	15	13	10	7	5
Foreign Bonds	8	5	5	4	3	3
High-Yield	-	2	2	3	3	1
Total Fixed Income	35	22	20	17	13	9
Real Assets						
Commodities	-	6	3	6	16	17
Real Estate	-	7	7	7	10	9
Inflation-indexed Bonds	-	-	-	7	5	7
Total Real Assets	-	13	10	20	31	33
Absolute Return and Special Situations	-	-	-	5	17	18
Cash	(1)	(5)	(5)	(3)	(5)	(5)
TOTAL	100	100	100	100	100	100

In addition to understanding the key characteristics influencing the long-term evolution of the global financial landscape, HMC's future success will depend, as we have noted on earlier occasions, on our ability to navigate the journey—particularly the extent to which we can discern and respond to an increasingly fluid and volatile economic, financial and geo-political landscape.

As you know, the global system is in the midst of important structural changes that offer new opportunities as well as a different configuration of risks. Ever larger pools of private and public investment capital are looking to mimic the “endowment approach.” And while imitation may be the highest form of flattery, such migration of capital will inevitably dilute the potency of the approach and complicate its implementation. This comes at a time when global payments imbalances remain large, correlations among asset classes and managers are rising, the market robustness of certain new derivative products is yet to be tested sufficiently, and a certain amount of hubris seems to influence some market participants who have confidently moved to a “just in time” risk management paradigm.

In view of this, we are resisting the temptation to extrapolate the recent strong investment performance. Instead, it is more prudent to view it as involving a “windfall gain” component. Indeed, the question is not whether there will be market pullbacks, but rather their likely depth, breadth, and duration. This consideration assumes added importance given the gradual decline in the traditional risk mitigating characteristics of a diversified asset allocation, thus further emphasizing the importance of HMC’s hedging and risk management strategies. Indeed, the July experience, as well as market developments so far in August, illustrates how these strategies can help the endowment navigate a challenging combination of sudden market disruptions and significant liquidity dislocations.

We look forward to continuing and deepening our dialogue with you. We greatly appreciate your continued support and commitment to Harvard. Please do not hesitate to contact us if you have any comments or questions.

Best regards,

Mohamed A. El-Erian
President and CEO