HARVARD MANAGEMENT COMPANY, INC.

Message from the CEO

JANUARY 2017

Dear Members of the Harvard Community,

Harvard Management Company (HMC) is undertaking a transformation to better position the endowment to support Harvard University for the long term. Please allow me to share my vision for the organization and to describe the changes we are making to accomplish our objectives.

My highest priority is to build an organization and investment strategy at HMC that will maximize returns at a level of risk appropriate for Harvard. HMC remains fully committed to the endowment model of investing with a highly diversified portfolio that includes long-duration, less liquid, and complex asset classes that will be an important driver to our success over a long-term investment horizon.

Organizational Changes

HMC has created significant value for Harvard University over the past four decades, but we now face challenges to our continued success. The investment landscape has evolved significantly, requiring us to adapt two aspects of HMC's organizational and investment models in order to maximize performance over the long term. The first is the hybrid model of investing, which utilizes a mix of internal and external investment teams, and the second is a "silo" approach to asset management that focuses team members as specialists in specific asset classes or strategies.

Internal Management at HMC

In the past, HMC's unique approach of investing in internally-managed portfolios generated superior returns. In recent years, however, the tremendous flow of capital to external managers has created a great deal of competition for both talent and ideas, therefore making it more difficult to attract and retain the necessary investment expertise while also remaining sufficiently nimble to exploit rapidly changing opportunities.

As a result of these dynamics, active hedge fund-like investments managed internally at HMC now comprise a very small percentage of the overall endowment. We can no longer justify the organizational complexity and resources necessary to support the investing activities of these portfolios. Therefore, we have made some important but very difficult decisions.

Today we announced that our remaining internally managed hedge fund teams will depart HMC by the end of fiscal year 2017. HMC is exploring investing relationships with these groups. Additionally, the team responsible for managing HMC's direct real estate investments is expected to spin out and become an external manager by the end of calendar year 2017. The real estate portfolio has been a key driver of returns for HMC since the direct platform was established in 2010, and the team will continue to be a valuable partner to HMC moving forward. Our natural resources portfolio, focused on timber and agriculture investing, will continue to be managed internally at this time.

As a result of these changes in investment strategy, the HMC organization will be significantly streamlined by the end of calendar year 2017, reducing the size of our 230-person staff by about half. It is exceptionally difficult to see such a large number of our colleagues leave the firm and we will be very supportive of these individuals in their transition. We are grateful for their committed service to Harvard and wish them the very best in their future endeavors.

Transitioning to a Generalist Investment Model

While internal management at HMC draws the most attention, I believe that our second organizational change is ultimately far more profound on a going-forward basis.

HMC's investment professionals have traditionally focused their work within specific asset classes. While this "silo" approach does bring the benefits of specialization, it has also created some unintended consequences. Portfolio managers conduct research and analysis and execute investment decisions within their respective asset class independent of the rest of the portfolio, sometimes creating both gaps in the portfolio and unnecessary duplication. This model has also created an overemphasis on individual asset class benchmarks that I believe does not lead to the best investment thinking for a major endowment.

As a result, HMC will transition this silo investment approach to a generalist investment model in which all members of the investment team take ownership of the entire portfolio. The team will have a singular focus: the performance of the overall endowment. HMC's existing investment professionals focused on externally managed funds will form the core of this generalist team. Importantly, the generalist model will be supported by a partnership culture in which the collective team engages in focused debates about investment opportunities both within asset classes and across the investment universe. Aspects of the generalist model are used to varying degrees by a number of leading endowments. HMC will create a version of the generalist model that best serves Harvard University.

To further support the establishment of our new investment model, HMC has named a chief investment officer and three new managing directors [see press release]. I have known these individuals personally and professionally for the majority of my career and they have extensive experience building and working within a generalist model and a partnership culture. I am confident these colleagues will be a great addition to the talented and experienced investment group here at HMC.

As we implement these strategic organizational changes, we must continue to be intellectually open-minded and creative. Conceptually, there is no reason why a generalist team could not hire managers internally, based upon an assessment of their potential alpha generation. While I don't expect a large portion of the portfolio to be managed internally as a practical matter (and as a result of the challenges outlined above), nothing is out of bounds in the future. In a more general context, I would expect HMC to pursue innovative strategies in a controlled manner in the years to come.

Additionally, an important part of our new investment model will be building a compensation framework that fully aligns the generalist investment team with the performance of the overall endowment. HMC, in conjunction with the HMC Board of Directors, will develop metrics to accomplish this objective. I expect that beginning in fiscal year 2018, compensation for investment professionals will be driven by aggregate performance of the overall endowment, not by siloed asset classes. This will incentivize a collaborative approach to endowment management as well as long-term thinking by the investment team.

Improving Our Processes

Over the next year, we will develop new investment and risk frameworks to improve our approach to decision-making at HMC. Our highly talented and capable technology, operations, and support teams will be integral to developing these frameworks. HMC is particularly fortunate that Bob Ettl, HMC's chief operating officer, has built and led these teams for the last eight years and will continue to do so for the forseeable future.

Our investment framework will consist of a disciplined series of processes that will guide the efforts of the generalist team. Some of these processes currently exist at HMC and will be integrated with new approaches to build one defined framework in which the generalist team can evaluate, initially and continually, the alpha potential of investment opportunities in a consistent manner.

We will also create a risk allocation framework as a lens from which to view the portfolio and as an important tool to appropriately match Harvard's risk appetite with HMC's portfolio. This framework will create focus on risk allocation, as opposed to asset allocation. That is, we'll move away from allocating our portfolio using categories of investments and toward allocating our portfolio based on its underlying exposures. Likewise, we will focus less on the portion of portfolio dollars invested in certain exposures and more on the portion of portfolio risk coming from those exposures. Columbia developed such a framework in 2004 and has been very well served by it. While this risk framework will take some time to develop at HMC, it will be an important discipline for us and one of our basic pillars.

Looking Ahead

Major change is never easy and will require an extended period of time to bear fruit. Transitioning away from practices that have been engrained in HMC's culture for decades will no doubt be challenging at times. But we must evolve to be successful, and we must withstand the associated growing pains to achieve our goals.

The HMC Board of Directors and I agree that transforming HMC's organization and portfolio is a five-year process. In retrospect, my experience at Columbia's endowment proved that it did indeed require about five years to position both the organization and portfolio in order to deliver strong risk-adjusted returns subsequent to that period. While I believe HMC's investment performance will be challenged in fiscal year 2017, by the end of the calendar year the organization will look and act very differently than it does today. It is also likely that our organization will experience more changes before we have completed our multi-year transformation. When complete, the organization and portfolio will be better aligned to maximize future risk-adjusted returns at the appropriate risk appetite for Harvard.

I should emphasize that our goal is risk-adjusted returns, not simply returns. There's a natural tendency to compare annual one-year returns among universities. However, different universities have different risk tolerances based on their own individual needs. Simplistic comparisons can be not only foolish, but also dangerous. Coming into 2007/2008 there was an arms race among the endowments to take on more and more risk, and many endowments, including Harvard, paid a severe price.

I am not suggesting that HMC should take more or less risk than others—we have to determine our own appropriate risk level through discussions with the University. While I was particularly pleased at one point when Columbia had the highest returns of any endowment over a ten year period while also taking less risk than most, I do think such a dynamic is an anomaly. To best serve Harvard, HMC will take a level of risk appropriate for Harvard. Our returns will ultimately follow in our chosen path rather than in the path of any other specific endowment, which might have a different risk tolerance and a different mandate. No doubt there will be critics and skeptics along the way. Nevertheless, I am confident that the HMC team, together with the HMC Board, will deliver.

After more than 18 years managing endowments at two other Ivy League universities, I understand that the mission of endowments is more critical than ever as universities face increased operating costs and decreased federal funding. It has never been more vital that we adapt to succeed. It is an honor to be part of the Harvard community and to work alongside an extremely talented and dedicated group of investment and operations professionals. There is much work to be done and I look forward to communicating our progress along the way.

Best regards,

N.P. "Narv" Narvekar
Chief Executive Officer