HARVARD MANAGEMENT COMPANY

Message from the CEO

OCTOBER 2021

Dear Members of the Harvard Community,

For the most recent fiscal year, which ended on June 30, 2021, the return on the Harvard endowment was 33.6% and the value stood at $53.2 billion. The endowment also distributed more than $2 billion toward the University's operating budget, which continues to represent more than one-third of annual revenue.

Performance

Asset Class	Allocation	Return
Public Equity	14%	50%
Private Equity	34%	77%
Hedge Funds	33%	16%
Real Estate	5%	13%
Natural Resources	1%	(1)%
Bonds/TIPS	4%	3%
Other Real Assets	1%	1%
Cash & Other*	8%	---
Endowment	**100%**	**34%**

**Cash held alongside equity index hedges used to reduce risk.*

Fiscal year 2021 was an extraordinary year. Public and private markets both continued their strong performance, which allowed the endowment to not only increase its distribution to the University, but also continue to grow during this critical time when pandemic-related financial pressures challenge all of higher education.

For each of the last three fiscal years, asset allocation/risk level was a significant determinant of returns—the higher the risk taken, the higher the return generated. The same was true in FY21, with one major difference. During the previous three fiscal years, the impact was measured in a few percentage points. In fact, during that period, HMC's strong alpha generation was enough to overcome the impact of a lower level of portfolio risk. By contrast, the impact of lower portfolio risk this past year was measured in tens of percentage points.

Put another way, given the extraordinarily strong performance of the overall market this past year, a meaningfully higher level of portfolio risk would have increased HMC's returns dramatically.

Specifically, key determinants of returns were:

1. Overall portfolio risk;
2. Venture capital, growth private equity, buyouts, public equity allocations and the directionality of hedge funds (all key expressions of portfolio risk);
3. Historical exposure to specific venture firms and vintage years 2009–2014, which had a dramatic impact upon FY21 returns (due to previous portfolio risk allocations).

Harvard's Risk Tolerance

During FY21, Harvard enjoyed tremendous returns, but also experienced the opportunity cost of taking lower risk. As readers of previous letters will recall, determining Harvard's risk tolerance (and therefore the appropriate risk in the portfolio) has been a topic actively discussed between HMC and the University, starting with my arrival in December 2016. Over the last decade, HMC has taken lower risk than many of our peers and establishing the right risk tolerance level for the University in the years ahead is an essential stewardship responsibility.

In order to maximize the endowment's returns in support of Harvard's mission, Harvard should take an appropriate amount of risk, subject to some important constraints. The main constraint for any university is its ability to absorb a significant reduction (even if only temporary) in the value of the portfolio and the resulting reduction in distributions critical to the annual operating budget. Furthermore, since most of the highest risk assets are illiquid ones (such as venture capital funds) a major decline in market/portfolio will generally result in a reduction in portfolio liquidity, a potential issue for both HMC and Harvard. How much portfolio risk can and should Harvard tolerate? While this appears to be a simple question, the answer is less obvious.

Accordingly, in 2018 HMC formed a Risk Tolerance group. This group includes board members, Harvard faculty, and colleagues from the Harvard administration, and is led by Jeremy Stein, the Moise Y. Safra Professor of Economics. Professor Stein and Harvard's CFO, Tom Hollister, have led us through an extraordinarily thoughtful analysis and debate, integrating Harvard's financial position, its need for budgetary stability, and its ability to handle more risk. It has been an honor and a great opportunity for HMC team members to be a part of and contribute to these discussions.

The level of portfolio risk is ultimately the most important and fundamental aspect of portfolio construction (reflected in asset/risk allocation) and a critical decision for the University. The findings and recommendations of our collective work will be reviewed carefully in the next several months, with ultimate oversight by the Harvard Corporation, and the decisions will direct and inform our management of the portfolio in the years ahead. I look forward to sharing our evolving thinking on portfolio risk levels in future letters.

We take pride in the fact that a deep dialogue with regards to Harvard's risk tolerance and its implications for HMC's portfolio is occurring. Ultimately, we all seek the appropriate risk level for Harvard, which might well be different from that of other university endowments. We believe that Harvard's financial future is very well served by this process.

Portfolio Initiatives

As discussed in the past, our portfolio initiatives over the last few years have aimed to:

1. Reduce Natural Resources exposure
2. Reduce Real Estate exposure
3. Increase Private Equity, especially growth and venture exposures
4. Reduce Public Equity exposure
5. Increase Hedge Funds, particularly those with low equity exposure and correlation

These initiatives are essentially completed, given our current risk tolerance level. Notably, the first three initiatives were driven by our investment views. All but the third initiative were also driven by our need to keep the portfolio within its current risk budget while adding to private venture and growth exposure. While reducing public equities proved to be painful in FY21, we needed to do so in order to remain within our portfolio risk budget. Overall, we are exceptionally pleased that we made these asset allocation moves, as they added about 5 percentage points to the FY21 portfolio return as compared to the FY17 allocation. Building a large hedge fund allocation during these past few years was also a way to mitigate risk as we significantly increased our unfunded capital commitments during the private equity and venture capital ramp-up period. This ramp-up period is mostly behind us now, though may go up a bit more should our risk levels increase.

As sophisticated observers are aware, building venture capital portfolios is a multi-year effort for several reasons: vintage year diversification, highly prudent manager selection, and the years it takes for these exceptional managers to competently invest our capital. Perhaps not surprisingly, a very large share of the tremendous gains from venture funds over the last year related to investments made over a decade ago. Therefore, our recent venture investments could take about a decade to bear fruit, though up rounds are happening much quicker today than in normal market periods. We expect an inevitable pullback, but also believe that certain tech and healthcare sectors offer great secular growth opportunities in the longer term.

Benchmark Relative Performance

As readers of previous letters will understand, we do not regard a focus upon benchmarks as a good way to invest. Nevertheless, I mentioned them in previous letters, and again here, simply as a way to show our early progress and success.

With regards to public markets (Public Equities and Hedge Funds) our four-year outperformance remains excellent—over 400bps on an annualized basis. While equivalent reporting for the private equity side of the portfolio is not yet available for FY21 close, we expect the four-year private equity portfolio benchmark relative performance to continue to be excellent and, therefore, expect that the four-year outperformance for the portfolio in aggregate to remain strong.

A Word of Caution

As experienced investors understand, Harvard's endowment will not produce 33.6% returns each year. Indeed, there will inevitably be negative years, hence the importance of understanding risk tolerance. Similarly, not every four-year period will generate the excellent benchmark relative performance or the absolute performance HMC has generated. What is more important is that our team, investment process/analytics, organizational structure, culture, and aligned incentives provide HMC with the framework for long-term success.

Net-Zero Efforts

As we highlighted in HMC's first annual Climate Report, our team is making aggressive progress on three considerable challenges toward the 2050 portfolio net-zero pledge: development of a comprehensive calculation methodology for the portfolio's greenhouse gas (GHG) emissions, data access from a wide range of external managers, and engagement with both asset managers and corporations.

Harvard was the first university to make a net-zero endowment pledge, but others have joined the cause as well. Consultation and collaboration with like-minded institutions will accelerate our efforts and establish standards that accurately reflect the real-world emissions of our investments.

While work on the net-zero portfolio continues, HMC recognizes that our own operations should meet that same standard. Since we believe we can do so well in advance of 2050, HMC became the first endowment office to announce that its own operations will be net-zero, beginning in FY22.

Our team looks forward to sharing more thoughts on both our operational and portfolio net-zero efforts in the annual Climate Report early next year.

Diversity and Inclusion

Early in FY21, HMC responded to an inquiry from Representative Emanual Cleaver, II and Representative Joseph Kennedy, III regarding diversity among our external asset managers. As we have discussed in the past, this is an issue of great importance to us as we believe that both our organization and our portfolio can only excel if we seek talent from the broadest pool possible. I encourage you to review our responses to their thoughtful questions and know that our efforts to broaden our pipeline of diverse managers and increase our investments with them continues.

In Closing

Shortly after our last annual report was released, HMC announced that we had completed our five-year organizational transition more than a year ahead of schedule. The changes we enacted, as a team, have drastically reshaped both the way HMC operates and the way we invest. I am tremendously grateful for the hard work that each member of our team has contributed over the past few years. There is certainly more work for us to do and we will always look for ways to improve and adapt HMC and our processes. That said, I truly believe that HMC and the endowment are on a pathway to best serving our singular goal to provide long-term financial stability to Harvard University.

Best regards,

N.P. "Narv" Narvekar
Chief Executive Officer