



September 2012

Harvard Management Company Endowment Report Message from the CEO

Introduction

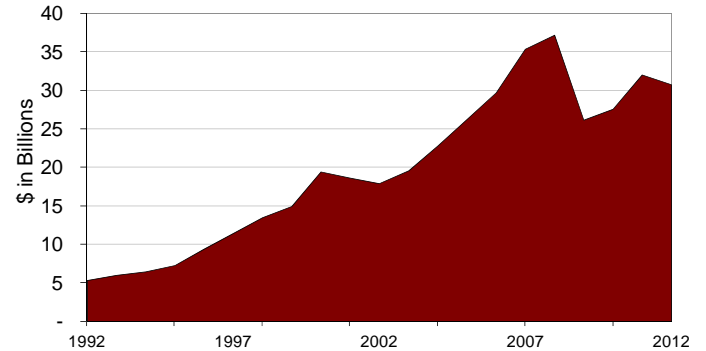
The return on the Harvard endowment for the fiscal year ended June 30, 2012 was essentially flat. The endowment earned an investment return of -0.05% and was valued at \$30.7 billion at the end of the fiscal year. The fiscal year 2012 endowment return was 98 basis points in excess of the -1.03% return on the benchmark Policy Portfolio. Adding value relative to the Policy Portfolio – beating the markets – is not easily done and is not expected every year.

This is the third consecutive year that Harvard Management Company (“HMC”) has beaten the Policy Portfolio. On a nominal basis, the average annual return for the endowment over the three year period since the financial crisis is 10.4%, exceeding the return on the Policy Portfolio benchmark by 125 basis points per year.

The markets during the last year continued to be choppy and highly sensitive to unresolved macroeconomic headwinds – with global equities down 6.5% for the year and the broad hedge fund industry experiencing total returns of -2.5%. In this context we are pleased that the endowment held steady and was able to provide substantial support to the University.

As long-term investors, we manage the Harvard endowment with three primary objectives: growth, liquidity, and risk management. While market growth over the last twelve months was well below long term averages, our portfolio benefited from the greatly improved liquidity and risk management we have built into the endowment over the last several years. We were also encouraged by the breadth of new investment opportunities we found through both internal and external managers during the year. We have invested in the best of these opportunities to enhance the positioning and balance of the overall portfolio and sow the seeds for future growth and alpha generation.

Total Value of the Endowment
(after distributions)



Historical Context

At HMC we are focused solely on providing strong financial support for Harvard University’s many areas of excellence through successful portfolio management. We are constantly aware of both the opportunities and the responsibilities presented by the long-term nature of the endowment. This pool of assets needs to be kept secure and to grow, in perpetuity. Such an extended investment horizon gives us an edge over the long-term, requiring that we think in decades, not months or years, when assessing the costs and benefits of our investment decisions and operating model.

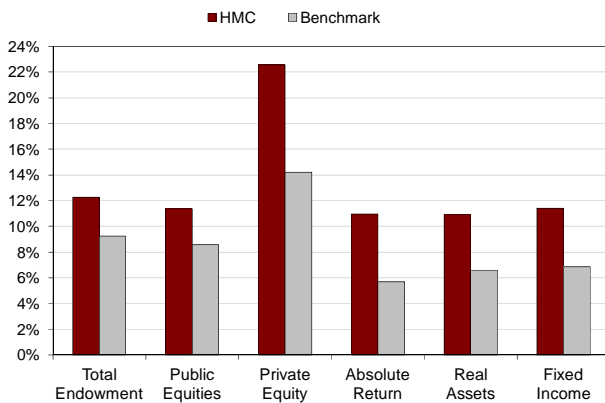
Investment Return
Annualized for Periods Greater than One Year

	<u>Harvard</u>	<u>Policy Portfolio Benchmark</u>	<u>60/40 Stock/Bond Portfolio *</u>
1 year	(0.05) %	(1.03) %	6.71 %
3 years	10.42	9.17	12.82
10 years	9.49	7.09	5.86
20 years	12.29	9.23	7.94

* S&P 500 / CITI US BIG

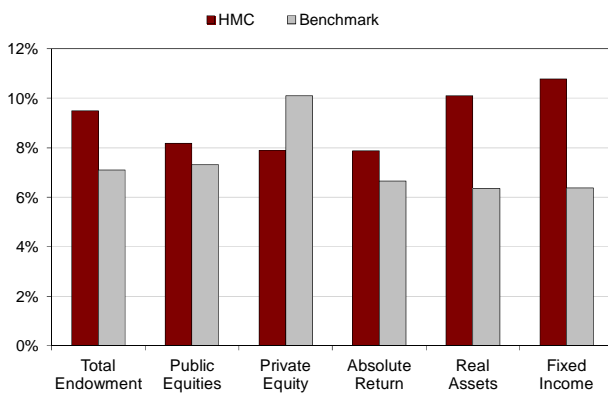
Over the past two decades the average annual return on the endowment has been 12.3%, beating our Policy Portfolio benchmark by over 300 basis points per year and a simple 60/40 stock/bond portfolio by even more substantial margins.

Annualized Twenty Year Performance



As markets and opportunities evolved over time, the drivers of Harvard’s investment performance have also evolved, but our strategy of broad diversification and our long-term performance across all major asset classes has delivered significant value-added in total and across markets.

Annualized Ten Year Performance



Policy Portfolio Benchmark

Each year, we review the long-term expected return, correlations and volatility for each of the asset classes in our diversified portfolio, and this work drives a thorough review and, from time to time, a revision of our benchmark Policy Portfolio. The Policy Portfolio is the mix of asset classes that we and the HMC Board

determine is best equipped to meet Harvard’s needs over the long term. It provides HMC with a guide regarding asset allocation and a measuring stick for performance. When our return is in excess of the Policy Portfolio’s return this means we have added value through active management. For more detail about the current [Policy Portfolio](#) and its evolution, visit HMC’s website.

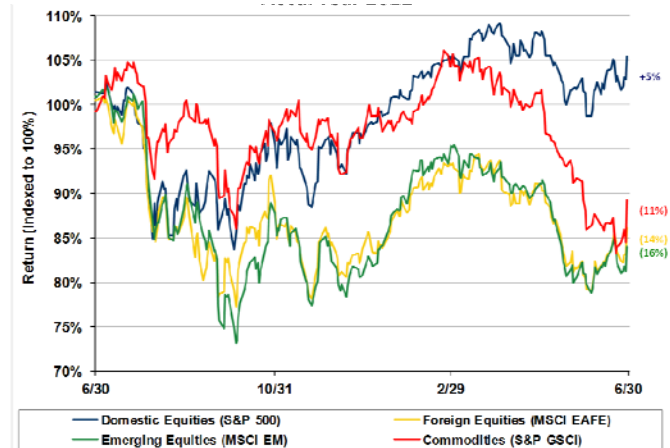
Discussion of Fiscal Year 2012

Market Overview

While we focus on the long term in setting our investment strategy, current markets are also important. Over the last few years markets have been quite turbulent and managing through complexity has become one of our themes since the financial crisis of 2008. The 2012 fiscal year provided plenty of evidence that this theme remains relevant. The first five months of the year were characterized by a sharp downward correction in the public equity markets, driven by the US debt ceiling debate, stress in the euro zone, and fears of a slowdown in the Chinese economy. Although not as disorderly, there were some moments involving negative returns and high correlations among asset classes that were reminiscent of the summer-fall of 2008.

By early fall 2011 the impact was significant – the S&P was down nearly 20%, European stocks were down 30%, and natural gas was down 25%. As fall changed to winter the world equity markets shook off their anxiety and recovered nicely, however market sentiment turned sharply negative once again in the spring.

Global Equity and Commodity Indices
Fiscal Year 2012





September 2012

Harvard Management Company Endowment Report Message from the CEO

Fiscal 2012 Performance

	<u>HMC</u>	<u>Benchmark</u>	<u>Relative</u>
Public Equities	(6.66) %	(9.05) %	2.39 %
Private Equity	1.99 %	4.04 %	(2.05) %
Fixed Income	7.95 %	7.85 %	0.10 %
Absolute Return*	0.81 %	(1.15) %	1.96 %
Real Assets	3.23 %	1.55 %	1.68 %
TOTAL ENDOWMENT	(0.05) %	(1.03) %	0.98 %

* Includes High Yield

Although we manage an exceptionally well-diversified portfolio, the endowment did feel the impact of market volatility during fiscal year 2012, especially in investments outside of the US. Despite these challenges, with our improved liquidity we have been active investors throughout the year in both liquid and illiquid markets. An example from each of these categories is discussed below.

Public Equities – U.S. and International

	<u>HMC</u>	<u>Benchmark</u>	<u>Relative</u>
Domestic Equity	9.65 %	4.08 %	5.57 %
Foreign Equity	(10.81) %	(13.97) %	3.16 %
Emerging Markets	(17.43) %	(15.95) %	(1.48) %
PUBLIC EQUITIES	(6.66) %	(9.05) %	2.39 %

This year continues our record of outperformance in the combined Public Equities asset classes (US, foreign and emerging markets). On a combined basis, Public Equities in our portfolio added 239 basis points to the equity benchmark return, through a combination of internal and external strategies.

Both US and foreign developed equities did very well relative to their market benchmarks last year, while emerging markets equities lagged their benchmark. Our US equity portfolio returned 9.7% (nearly 560 basis points over the US equity broad market benchmark).

We should note that Harvard carries relatively more exposure to both foreign and emerging markets than many of our peers. Our portfolio has roughly equal allocations to US, international developed, and emerging markets equities. The difference in returns among these markets was dramatic over the last twelve months, as can be seen from the Public Equities table above, but we remain convinced that active investing in emerging and international markets is not only wise, but imperative over the long-term.

We are now living and investing in a truly global economy: manufactured goods, commodities, capital, human talent, and services are shipped across borders

and between hemispheres continuously. If chosen and executed well, emerging markets investments are poised to benefit from the phenomenal rate of change in local, regional, and global businesses worldwide and will be one of the key drivers of our portfolio's future performance.

Real Assets

	<u>HMC</u>	<u>Benchmark</u>	<u>Relative</u>
Real Estate	7.92 %	6.80 %	1.12 %
Natural Resources	2.40 %	0.86 %	1.54 %
Publicly Traded Commodities	(8.14) %	(12.47) %	4.33 %
REAL ASSETS	3.23 %	1.55 %	1.68 %

As long-term investors driven by fundamentals, Real Assets investments hold strong appeal. Our definition of Real Assets includes Real Estate, Natural Resources, and Publicly Traded Commodities. These three areas together make up about 25% of the total portfolio.

We like the Real Assets theme for Harvard for several reasons: (a) long term supply/demand characteristics and trends in many of these markets are favorable; (b) execution can be more complicated than in other investment areas, giving experienced investors an advantage; and (c) investors with a long term view or more flexible timeline can do significantly better than those that are forced to transact by their specific investment mandate or time horizon.

Part 1 - Real Estate

Our revitalized real estate team and strategy, now about three years since inception, is beginning to bear fruit. Historically HMC's real estate strategy was focused exclusively on investments in private-equity-style real estate funds run by third-party managers. We are now investing a significant portion of our new capital in real estate through a direct deal/joint venture approach in specific market niches. This provides HMC much more discretion over capital allocation across markets and sectors, leverage, and development risk, as well as lower management fees. The assets invested in our new strategy returned about 15% last year. Our total Real Estate portfolio was up about 8% for the same period and outperformed its market benchmark.

Part 2 - Natural Resources

Our Natural Resource portfolio comprises hard assets, primarily timberland, agricultural land and other resource-bearing properties located around the world.



September 2012

Harvard Management Company Endowment Report Message from the CEO

Our investment thesis in Natural Resources is fairly simple. We like the asset class because we believe its physical products are going to be in increasing demand in the global economy over the coming decades. At the same time, the supply of these physical products cannot be increased easily or quickly. In timberland, for example, it takes decades to produce incremental timber resources, while growing economies continue to demand more and more timber products today in order to build out infrastructure and satisfy growing consumer needs. While we expect to see cycles in Natural Resources pricing, the inefficiencies in these markets can create excellent transaction opportunities, especially for investors like Harvard that have the ability to hold their investments for a long period of time.

Another reason we like this asset class is that experience counts. As a first mover, Harvard has developed a strong Natural Resources investment team including local market and natural resource specialists. Our expertise and scale allow us to make direct investments in individual properties, where we can have greater control over outcomes.

Sustainability is a key element of our natural resources investment strategy. We aim to manage so that our properties will be more productive with improved environmental outcomes at the end of our ownership period. We believe that by increasing the health and productivity of our assets, we will realize better value.

Returns in our Natural Resources portfolio were modest over the last 12 months at 2.4%, about 150 basis points over our benchmark. Since inception in 1997 our Natural Resources portfolio has delivered an average annual return of 12.7% versus the benchmark return of 6.7%.

Part 3 – Publicly Traded Commodities

The third leg of our Real Assets platform is broad-based exposure to Publicly Traded Commodities. In this area we use a mix of internal and external management, with the common theme of applying strategic insight in individual markets or commodities in order to beat the public commodities indices.

Our internal management team in this asset class was new last year and got off to a very strong start, delivering over 1,100 basis points of return over our commodities benchmark. In total, our combined Publicly

Traded Commodities strategies added over 400 basis points of value relative to the commodities benchmark.

Inside HMC's Investment Process

At HMC we use a combination of internal and external teams to manage parts of the Harvard endowment in both public markets and alternative asset classes. Our process for evaluating investments for inclusion in the portfolio may vary by strategy, but always involves fundamental market analysis, asset valuation (and a plan for realizing that value), and assessments of expected return and risk. Our investment professionals' analysis is augmented by legal and operational due diligence conducted by separate dedicated teams within HMC. In every case, we consider several factors including:

- *Quality.* The quality of the underlying investment asset as well as the risk/reward profile of the investment must meet the standards of the world's largest endowment portfolio.
- *Innovation.* We strive for and value innovation in investment opportunities, with investment partners, and in our own organization. We know that the areas of best performance from prior decades will not necessarily give us our highest returns going forward, so it is imperative that we continue to look for innovation in our managers and in our own investment strategy.
- *Long Term Sustainability.* We are, by the nature of our mission, concerned with responsible stewardship and sustainability. While we are careful to avoid constraining our investment universe unnecessarily, we are responsible investors who fully vet potential investments and investment partners for long-term viability. We hold ourselves and our managers to a high standard regarding areas such as environmental stewardship, labor practices, and good governance.

Organizational Update

Our company and our portfolio have stabilized and strengthened from their post-financial crisis state. Regarding the HMC organization, with a few near-term planned additions to our internal equities team, we anticipate being fully staffed on both the investment and support sides for the first time in several years. Our upgraded risk management team is providing essential and continuous input to our investment management functions. We have made good progress on rebalancing the mix of liquid and illiquid assets in our portfolio, although we are not quite where we want to be yet.

The experience, quality and commitment of our staff have never been better. Our portfolio management team in Boston is comprised of individuals with a diverse



September 2012

Harvard Management Company Endowment Report Message from the CEO

combination of backgrounds, cultures, and nationalities (many of whom share a direct connection to Harvard University).

We also continue to draw on the experiences and expertise of Harvard's broad global network, especially in areas such as China, India, Brazil, and other parts of the developing world. Harvard's unique reach has often provided us with deeper insight about opportunities and risks, and influenced the path of our thinking about how to best shape Harvard's portfolio going forward.

Looking Ahead

One of the messages I constantly reinforce within HMC is that we can never stop evolving as stewards of Harvard's most valuable financial asset. We need to continually "up our game" as active investment managers, staying alert to change and focused on new opportunity. The world of investments changes every year – with more dollars, more analysts, and more investors of all types looking for additions to their portfolios that they hope will generate outstanding returns.

This is a time of unusual turbulence with significant macroeconomic issues facing regions around the world. While future returns may be uncertain, our strategy is to remain well diversified and focused on long-term value creation. We continue to concentrate on generating alpha on both a domestic and international stage.

Thank you for your support.

Sincerely,

Jane L. Mendillo
President and Chief Executive Officer