The 'genius' of Harvard's enduring hedge fund legacy

Weed to 'wonder-fund': the oldest and largest US university endowment continues to lean on both internal and external expertise

By Susan Barreto

The story of Harvard Management Company is one of trial and error (arguably the best way to learn), and failure (where the lesson learned has clearly led to unprecedented success).

Over the last 15 years in particular, the endowment has experienced its greatest returns, endured its greatest criticism and seen its investment policy evolve to become the envy of institutional investors worldwide.

The endowment fund that now boasts nearly $40 billion has had its fair share of critics and admirers, but its reliance on hedge fund strategies has done nothing but grow alongside a portfolio that in 1990 was approaching a mere $5 billion.

Jane Mendillo

Back then, Harvard managed its own portfolio made up of mainly traditional stock and bond investments. Now the management company manages complex derivative and private equity programmes and farms out nearly half of its assets, some of which are managed by Harvard endowment alumni. Roughly 18% of the portfolio is now invested in absolute return strategies, with a fair number of those strategies receiving their seed capital from the endowment.

Jane Mendillo, former chief investment officer of Wellesley College, joined Harvard Management as president and chief executive in July. During her six-year tenure at Wellesley, she directed the restructuring of the $1.7 billion investment portfolio and set up the college's first investment office.

Mendillo returned to the Harvard endowment office after previously being one of Harvard's senior investment officers before leaving for Wellesley.

In coming back, Mendillo said: "The Management Company's investment rigor, intellectual integrity, and – most important – superior returns are traditions I look forward to continuing. Moreover, the depth of talent and ability at HMC provide the foundation for continued investment excellence in support of the University."

Harvard's endowment returns have been in the double-digits in recent years. As of 30 June 2007, Harvard earned 23% and grew the portfolio by almost $5 billion in one year. While real estate and private equity portfolios were the stars of 2007 and commodities are expected to have added a polish to the portfolio in 2008, hedge funds have remained a steady constant.

"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," reads the annual John Harvard letter in 2007.

The dependence on absolute return strategies and hedge funds began with Jack Meyer in the 1990s. He was brought to HMC in September 1990 to turn around the fortunes of Harvard's $4.7 billion portfolio that had been performing below the national average of university endowments as compiled by the National Association of College and University Business Officers (NACUBO).

Meyer, former chief investment officer of the Rockefeller Foundation, took over from 1954 Harvard graduate and founding HMC President Walter Cabot. According to Harvard's newspaper, *The Crimson*, many alumni had feared that Cabot had lost control after years of decentralised leadership. Meyer was set to change all that and had an ambitious plan to establish a new asset allocation and to set up a new system of internal benchmarks that varied by strategy.

Meyer's early years at HMC were not met with alumni favour

either as the endowment continued to underperform 71% of other university endowments. As one of the largest capital campaigns was set to begin, Meyer was criticised by alumni who said the $2 billion campaign would not have been necessary had the endowment been managed properly. Some even suggested that HMC join the Commonfund Group, which had offered to take on Harvard's assets back in 1971.

HARVARD'S RAPID GROWTH

Year	Assets	Compound annual return	% in hedge funds
1990	$4.7bn	7.50%	0%
2000	$18.2bn	32.00%	5%
2001	$19bn	- 2.7%	5%
2002	$18bn	- 0.5%	12%
2003	$19.3bn	12.50%	12%
2004	$22.6bn	21.10%	12%
2005	$26bn	19.20%	12%
2006	$25.9bn	16.70%	15%
2007	$38bn	23%	17%
2008	$40bn plus	9% (expected)	18%

His goal was to firmly establish a 'policy portfolio' that would become the benchmark against which future tactical asset allocation decisions were made. The shake-up was the most radical in the endowment's 372-year history. According to a Harvard Business School case study, Harvard's endowment was considerable, but not without its own financial pressures.

"In so far as a new asset allocation policy could yield greater expected long-run returns from the endowment, it could support greater spending rates and thus contribute substantially to alleviating the current financial pressures," the case study concluded.

The asset mix was enhanced to include non-traditional investments, including an aggressive short-term trading account, which pursued opportunities such as warrant and various arbitrage strategies.

The addition of short stock portfolios was implemented, while a tactical asset allocation strategy included futures and other derivatives trading strategies. Roughly one quarter of the endowment was invested in private non-marketable assets managed by the Aeneas Management Company, a subsidiary of HMC.

Investing in venture assets followed in the footsteps of Yale University's David Swensen, who had profited from such investments in heading up Yale's portfolio since 1985.

In preparing for the asset allocation, Meyer is understood to have collected data on the asset allocation of five other nationally prominent university endowments, including Yale. He was an early proponent of alternative investments at the Rockefeller Foundation.

It was decided that a long-term policy would be established, while a short-term policy portfolio would be managed within the ranges of the long-term investment policy. That way, small changes to the asset mix could be made without returning to the board for approval.

Internally managed hedge fund strategies and leverage sparked criticism, but were likely the key components behind much of the turnaround of the endowment later in the 1990s.

Meyer spoke out defending his performance of 1992, saying that diversification in the long term would pay off although it had hurt returns over the course of the year. While some compared the endowment to a casino, the reality was rapid growth of the endowment portfolio (see table above) that far exceeded the much maligned capital campaign of previous years.

As of the fiscal year-end in 1995, Harvard's endowment with $7.7 billion in assets had more than $35 billion in outstanding positions. That translated into roughly $21.5 billion in long holdings and $13.8 billion in short plays. Under Meyer, the portfolio management team grew to 150 full-time staffers and roughly 85% of the portfolio was internally managed. At the same time, the compensation structure was significantly revamped to reward talent and to keep top talent in the HMC fold.

The typical Harvard fund manager would be paid a salary and a 'neutral' bonus that in turn could be equal to an individual manager's salary. That amount alone was not overly generous by traditional money management standards.

Once an incentive bonus is added, that is when some salaries could become hefty and move very quickly into the millions. A performance bogey was established for each individual manager and was generally tied to a specific market index, then each individual received an incentive bonus for every 1% they outperformed or underperformed their respective bogey.

The maximum negative incentive bonus was equal to the neutral bonus, so if a manager performed poorly they would only receive their salary and no bonus.

The top HMC management reporting to Meyer expected to be paid in a comparable manner, but their incentive compensation would be tied to the performance of the endowment fund as a whole.

In 1998, Harvard earned 20.5% overall, while the endowment's top paycheck totalled more than $10 million for the first time and the top earner was not Meyer. Jonathan Jacobson had recently left HMC office, after taking home $10.2 million and $7.6 million the year before. Altogether, five Harvard managers and Meyer took home $45.4 million, which was nearly four times more than the top six executives were paid two years earlier.

As the stock market collapse of 2001 and 2002 hit, Harvard and other big endowments largely avoided the downturn thanks to hedge fund strategies. The genius of the Harvard endowment 'hedge' model was beginning to be praised, although the returns were not as stellar as they had been in 1998 or 2000.

"Years later it was confirmed to me how original the structure of Harvard Management Company was under Jack Meyer," says Hilary Till, who was an equity analyst at HMC from 1992 to 1993. Till, who is now a principal of Premia Capital and research associated at the EDHEC Risk and Asset Management Research Centre in Nice, France, adds: "Whenever I mentioned that I had once worked at Harvard Management Company, listeners would lean forward and be silent like in the old EF Hutton television ads."

Meyer too believed in the Harvard model, so much so that he proposed taking external money for the group to manage. The board quickly shot down the idea as public pressure grew over the exorbitant pay days at the endowment office. As Meyer's 'hedged' returns were beginning to bear fruit, the managers responsible for those gains began to depart in an exodus that would last roughly eight years (see chart opposite) and Harvard would shell out $3.5 billion to its hedge fund seedlings.

HMC's top equity manager, Jonathan Jacobson, was one of the first departures. He launched Highfields Capital in 1998 with $500

million in seed money from Harvard. At the time, Meyer was quick to warn that other managers would likely leave unless manager compensation was boosted.

According to our sister publication, *Absolute Return*, Jacobson has in recent years taken an interest in philanthropy, forming the $76 million Jacobson Family Trust Foundation. Highfields now manages roughly $11 billion.

Two of Harvard's top earning portfolio managers left to form Adage Capital in 2001. High-profile Harvard managers Phillip Gross and Robert Atchinson took in a whopping $1.8 billion from Harvard Management to form the new hedge fund. Now the firm totals more than $8 billion in assets and also is a favourite among US foundations and endowments.

It took another couple years for the compensation argument to bubble over again at HMC. In roughly 10 years, Harvard had moved from being 85% managed internally to running only about 55% in-house, so in theory the cost of managing the growing portfolio was rising rapidly, although it is hard to gauge since external management fees are not publicly disclosed.

In 2004, it was revealed that Harvard paid its top performers $108 million the previous year, which once again sparked controversy. Alumni of the Harvard class of 1969 sent a letter to Harvard president Lawrence Summers, criticising the pay of managers such as David Mittelman, who reportedly received $25.4 million to manage a $2.4 billion domestic bond portfolio.

In response, HMC said it would cost more to farm out all its assets to external managers than to pay talented managers what they were worth. Shortly after the highly publicised spat, Jeffrey Larson and Stuart Porter left to form Sowood Capital after pocketing millions in salary and bonuses at the university endowment. Harvard allocated $500 million in start-up capital for the new hedge fund and another $200 million was invested in a new commodities fund.

As its staff were becoming the darlings of Wall Street, with a Harvard pedigree to boot, the endowment's annual returns had risen to 19% annually. This left critics with little ammunition at the end of the Meyer administration. It was not until 2005 that Meyer decided to start his own hedge fund and the following year his Convexity Capital would take in $500 million from HMC.

Meyer took a number of high profile staffers with him, including Mittelman and Maurice Samuels, who continually tipped the pay scale until their departure. All told, Meyer's hedge fund would launch with more than $6 billion in assets.

Meyer's departure left an asset mix that grew to include up to 15% in hedge funds. As Meyer stepped down, Harvard came to rely heavily on its absolute return asset classes to boost returns. The gains in hedge funds – 37.8% in emerging markets and 26.5% in developed foreign equities – bolstered the portfolio as bonds became a drag on the overall portfolio.

Mohamed El-Erian replaced Meyer as president and chief executive officer in 2006. The investment office also tapped Mark Taborsky from Stanford University to oversee the absolute return portfolio. El-Erian planned to focus on new investment opportunities arising from increasing globalisation.

His tenure was short-lived, however, and his public relations disaster came in the form of Sowood Capital, which came as the university intended to boost its hedge fund portfolio to 18% of assets. The Sowood Alpha Fund lost more than 50% in July 2007, bringing its loss for the year to 56%. The firm's assets dropped to $1.5 billion and translated into a loss of $250 million or more for Harvard.

Despite the failure of Sowood Capital, Harvard managed to produce a stellar 23% return and grew the investment portfolio to $40 billion. In the annual John Harvard letter it was said the Sowood investment accounted for a decline of about 1% of the endowment portfolio.

"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 related hedges implemented in the context of our overall risk management process," El-Erian wrote in the 2007 annual John Harvard letter. A few months after writing those words, El-Erian left HMC to return to Pimco as co-chief executive officer and co-chief investment officer at year-end.

Harvard has traditionally kept its hedge fund holdings close to the chest. Besides the number of seed arrangements with former staffers turned hedge fund managers, the university is known to have at least $500 million with Eton Park and roughly $700 million with Gavea Investments, a Brazilian hedge fund.

The entire hedge fund portfolio at Harvard is thought to total nearly $7 billion, which may end up being on par with the allocations of the California Public Employees' Retirement System and other US public pension plans that could see their hedge fund holdings swell beyond the $10 billion mark.

Whether or not Harvard grows its hedge fund portfolio, there may be some taxing times ahead. Earlier this year, Massachusetts legislators passed a measure that would impose a 2.5% tax on the nine largest endowments in the state. The essence of the bill is something Harvard has asked itself many times over the years – is HMC a charity or a business?

This is just part of the challenge facing incoming HMC president Mendillo. In a year when even the traditional investments and alternatives are struggling, Harvard may not reach its lofty returns of years past. Whether this means admissions will increase or another capital campaign could be on the way is doubtful as the health of the overall endowment will likely remain intact.

Harvard will continue to be asked to prove its hedge fund investment prowess regardless of whether or not its internal or external hedging strategies pan out. And chances are, like a well-read student, it will have some good answers in hand.

HARVARD'S HEDGE FUND GRADUATES

Firm name	Harvard Management Company Alums	Year of departure	Harvard allocation ($m)
Lansdowne Partners	Steven Heinz	1998	$0
Highfields Capital	Jonathan Jacobson	1998	$500
Adage Capital	Phillip Gross and Robert Atchinson	2001	$1,800
Sowood Capital	Jeffrey Larson and Stuart Porter	2004	$700
Convexity Capital	Jack Meyer, David Mittleman, Maurice Samuels Edward DeNoble, Michael Pradko, Shawn Martin	2005/2006	$500
Avenue Capital Group	Robert Russell	2007	
		Total	**$3,500**