Inside the Harvard Management Company

By Robert Huebscher
March 31, 2009

Trial by fire would be an understatement.

A mere six weeks after taking the helm of the Harvard Management Company, which oversees the nation's largest university endowment, Jane Mendillo confronted the Lehman bankruptcy and the unraveling of the financial markets. Since then, Mendillo has been forced to make abrupt changes to the endowment's asset allocation in order to raise cash, while her portfolio has suffered the worst returns in its history.

In a speech to the Boston Security Analysts Society on March 25, Mendillo discussed her market outlook and the changes she has made to Harvard's asset allocation, organization, and operating principles.

Mendillo is "cautious" about the current markets, despite the recent, near-20% rally. She is "neither rushing for the exits nor rushing back in," she said, but she has raised cash allocations. Though she has reviewed several very attractive real estate opportunities, she believes the time to invest is still two or three years away.

Mendillo is "not sure" that the current rally "is supported by the economics or the fundamentals," she said.

Significant parts of Harvard's portfolio are not generating cash, Mendillo said, but "we will continue to support the very best managers."

This is Mendillo's second stint at Harvard, where she worked starting in the mid-1990s. Prior to taking charge of Harvard's endowment, she oversaw Wellesley College's endowment. Mendillo had previously served as Harvard's Vice President of External Management, during which time she initiated a timberland investment program under which the university acquired large tracts of land in the Pacific Northwest and in the Northeast. Those holdings have since been sold – many at substantial profits – and replaced by investments in natural resources.

In her former position at Harvard, which she left in 2002 to take the Wellesley job, Mendillo oversaw the endowment's private equity, venture capital, real estate, and distressed situation investments. These illiquid holdings are at the core of the problem Harvard now faces.

She has no regrets about accepting her current position, citing Harvard as the "pinnacle of the endowment profession."

Harvard's fiscal year ends June 30, and Mendillo shared the endowment's performance over various time periods:

	Annualized Total Return	Policy Portfolio Benchmark	Performance v. Benchmark
FY 2008	8.6%	6.9%	1.7%
5 years	17.6%	13.5%	4.1%
10 years	13.8%	9.5%	4.3%
20 years	14.2%	12.0%	2.2%
30 years	14.6%	12.9%	1.7%

The Policy Portfolio benchmark is an average of returns, weighted by asset class, measured across similar institutions, constructed to mirror Harvard's asset allocations. Mendillo noted that the median return for peer institutions over the last 10 years was 6.1%, and that Harvard's outperformance relative to this median added $23 billion to the endowment as of June of last year.

Mendillo took her position in July of 2008, the end date of the figures cited above. The endowment's performance during the first few months of this fiscal year, through the end of October, was miserable – down 22%. Mendillo declined to provide more current numbers, only to say that "overall performance is not that different as of today, and we are slightly ahead of our policy portfolio."

"This magnitude of loss has never happened in the history of the endowment," she said. Single digit losses occurred in 2001 and 2002, and the endowment faced negative nominal returns in the 1970s, coupled with high inflation, but neither episode rivals the scope of losses the current portfolio has suffered.

As a result, the university pulled back on some initiatives, most notably a major planned expansion into the Allston area.

"The current environment will not change our goals," Mendillo said, "but it will change the timing of many projects."

"It will take some time – perhaps many years – to build back up to where we were prior to these losses," she said.

Mendillo currently has 34% of the portfolio in public equities, 17% in private equities, 18% in absolute return strategies (hedge funds), and 26% in real assets (real estate and natural resources). Within public equities, she is equally allocated among domestic, foreign, and emerging markets – an allocation that reflects a shift toward non-US markets in recent years.

Typically, the endowment has a -5% cash allocation, using leverage to invest 105% of its assets. That decreased to -3% earlier this year and today is “seriously positive,” according to Mendillo. Starting in July, she decided to raise cash to create room for new investments and to capture profits on existing ones. Since then, she has been forced to raise cash to provide funds for Harvard’s operating expenses, often by selling illiquid investments.

But reports that Harvard was forced to sell $1.5 billion in private equity investments for “pennies on the dollar” are completely untrue, Mendillo said. She did begin evaluating options to reduce private equity exposure shortly after joining the firm, she said, but market conditions rapidly deteriorated from “pretty good” to “absolutely horrible.”

“We have not taken a major chunk out of private equity,” she said.

Illiquid investments still constitute a large slice of the endowment’s assets, with 13% in private equities, 9% in real estate, and another 9% in natural resources. These investments were designed to be self-funding, with cash flows sufficient to handle cash calls. That relationship has broken down, as has Mendillo’s appetite for additional illiquid investments.

A staff of approximately 20 individuals oversees those illiquid investments for Mendillo, evaluating and monitoring external managers. When she left Harvard in 2002, 70% of the endowment was managed internally and 30% was managed externally. Today those percentages are reversed; employees have left, started hedge funds and now manage funds for the endowment. Mendillo still relies heavily on her internal staff to manage emerging market equities and domestic and foreign fixed income. By contrast, Yale’s endowment, managed by David Swensen, relies entirely on external managers.

Mendillo mixes active and passive strategies in the public markets, indexing when she believes Harvard has no clear advantage in a specific market. She also uses a subset of hedge fund strategies, and she is not committed to investing in every hedge fund discipline.

Typically, Harvard spends between 4% and 6% of its endowment each year, an amount that funds up to 30% of the university’s operating budget. During years of double-digit returns, Harvard was able to stay in the lower bound of that range while stellar performance enabled Harvard to provide broad scholarship programs on a need-blind basis.

The broader question Harvard, along with other major endowments, must ask is whether the "endowment model" of asset allocation, with its major commitment to illiquid investments, will continue to work in the future. Mendillo's faith in the approach appears unshaken, but that confidence is being tested in the current environment, as pressure mounts to provide liquidity to support operational needs.