Harvard's Post-Crisis Endowment Strategy

By Justin Kermond
January 28, 2014

Jane Mendillo took the helm as CEO and president of Harvard Management Company (HMC) in 2008, after the endowment suffered a devastating $10 billion loss, which depleted its worth by more than 27%. Under her leadership, HMC has emerged from the crisis with innovative changes in its policies and processes regarding asset allocation and risk management of alternative assets.

Although the endowment's assets were valued at $32.7 billion as of June 30, 2013, it has yet to recover to its pre-crisis size of over $36 billion. More than half – 55% – of the endowment is invested in alternative assets and that allocation has increased since 2008.

In a recent meeting of the Boston Security Analysts Society (BSAS) on the challenges and opportunities for investors in 2014, Mendillo discussed these changes in a "fireside chat" moderated by Stacey Marino, a BSAS board member and senior portfolio manager and vice president at State Street Global Advisors.

Mendillo discussed the steps she took to help the endowment recover from its post-crisis lows, including how her thinking evolved on the excess return she expects from private equity to compensate for its lack of liquidity, the advantage of taking a more controlled and direct approach to real estate investing, the advantage of managing investments internally and externally, the disadvantages to size, the opportunistic approaches to alternative investments, and the understanding of risk exposure with hedge funds.

HMC's singular mission since 1974 has been to support Harvard by investing and enhancing the University's financial resources for the long term. The underlying framework of the Harvard endowment is the policy portfolio, a concept that has been employed by HMC for many years. It is a theoretical portfolio allocated among asset classes to maximize potential return and minimize risk over the long term. The policy portfolio differs from a traditional stock/bond portfolio in that it includes allocations to less traditional and less liquid alternative asset categories, such as private equity, real estate, absolute-return hedge-fund strategies and natural resources. The endowment is managed with a hybrid model, employing both internal investment professionals and third-party managers.

Mendillo said that HMC needed to focus on three things and "reinvent" to move forward after the crisis. They needed to be positioned for growth, as Harvard has a tremendous need for capital from the endowment to spend toward its operating budget. The portfolio managers needed to be very cognizant of and provide more thought-leading risk management. They needed to innovate structure around how they think about liquidity versus illiquidity. Due to the troubles in managing illiquid exposures during the financial crisis, the pendulum has swung back toward more liquid alternative assets. The portfolio's 55% allocation to alternatives is "about the maximum of what we would like to do, given the needs for liquidity from our portfolio for the University and for investment returns," Mendillo said.

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Mendillo discussed risk factors versus asset-allocation models and the illiquidity risk premia in the context of private equity. “When we lock up our money for seven years, eight years, 10 years, it should be that there is a significant return over and above what would be earned on average in the public markets. We’ve gotten more precise, more disciplined, more hardheaded about that in the wake of the financial crisis.”

“The private equity world is much, much more crowded today. Private equity managers have raised about $1 trillion that is yet to be invested”, she said. She concluded that she cannot expect the same illiquidity premium on private equity over public equity as was the case historically. HMC currently focuses instead on the dynamics of supply and demand in those markets and the investment opportunities. “Due to this large flow of money, setting up an allocation of 15% in private equity and saying that’s where we want to get would probably be folly,” she said.

Mendillo spoke about alternative investments in the context of traditional asset-class risk-return correlation relationships versus more risk-oriented approaches. As the money flowing into the alternative investment arena has increased, Mendillo has altered HMC’s strategy to be more opportunistic in taking advantage of associated investment cycles. The company’s previous experience working with externally managed real estate investments “was that most of the fund managers in real estate that we signed up with had a tendency to ride the cycle up, and so valuations within the portfolio got to be very attractive, but (these fund managers would) not really get out unless it was toward the end of their fund cycle and so ride it down again,” reducing returns. In response to that frustrating experience, HMC has made significant investments in real estate over the last four years with an altered strategy to ensure that the portfolio is more actively capturing the ups and downs of real-estate investment cycles. These investments are made “through joint ventures and direct deals where we can control the entry, we can control the exit point, and it isn't a ‘put your money in the fund and get it back in 10 years’” strategy, she said. “Real estate is a very segmented market. We pick sectors or segments within the real estate that we think are priced for juicy returns, get into those on a more efficient basis, then get out when they’ve been re-priced”.

Mendillo said HMC prefers to use internal investment managers rather than outsourcing to external managers. “It's a cost-effective way to manage money, gives us a lot of flexibility, a lot of transparency and a lot more risk control than allocating money outside,” she said. HMC’s fixed-income portfolio is managed internally, while much of its public-equity assets are managed by external managers. The largest external equity manager was formerly an in-house team before it spun off to be an outside firm. “Private equity requires a lot of diversification and more and more specialization, by geography, by history, and by sector,” she said. “To have private equity in-house staff that could compete with the thousands of outside managers that are looking at private equity deals on a daily basis would probably be impossible for us to find those nuggets that others hadn’t already discovered”. HMC started investing in timber in the 1990s with an in-house team, as there were few external managers in natural resources. They have continued to manage those investments in-house.

Though most of the venture-capital industry is “kind of ho-hum,” the best managers can produce “outstanding” returns, Mendillo said. Although HMC has been very successful developing relationships and identifying the best venture capital managers, she expressed frustration that its allocations to those top managers are capped at dollar amounts. Even though HMC manages a $35 billion fund, it is usually capped

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at the same dollar amount as a $10 billion or $5 billion fund. As a result, they are not getting much exposure for their size.

Mendillo offered a cautious view on derivatives and structured products, while stressing the importance of a thorough understanding of what these investment products are, what goals they accomplish, and what additional risks they create. “There were a lot of products — and there still are a lot of products — that are sold to us as a substitute for direct exposure or real exposure in an asset class, but embedded in those products, structured notes for instance, is an invisible but substantial fee to the investment bank offering the structured note.” She said this is another lesson from the crisis that is obvious and worth repeating with each investment.

Mendillo admitted it is extremely challenging to understand the risks associated with HMC’s collection of hedge fund investments, as there is “no real definition” to the asset class, HMC is focused on active screening and research to pull apart the risks in the absolute return portfolio to understand how those risks might augment or offset risks in other parts of the portfolio. The absolute return portfolio is designed to have a lower beta than hedge fund indices. What Mendillo wants to get out of the absolute return portfolio is return that is uncorrelated with the public markets. “If we’re looking for truly uncorrelated returns and likely to be positive rather than negative on a nominal basis, it turns out that … a lot of things labeled as hedge funds don’t come through that screen.“

Mendillo closed out her comments stressing the importance of being opportunistic with alternative-investment allocations. Although HMC does have shadow target allocations in each alternative asset area, she is pushing to take advantage of opportunities rather than being tied to allocation targets. “If natural resources are overpriced because there are too many people that are interested in that area, then we don’t have to have our target allocation in natural resources. We could be half of that, and that may be something that changes in 2014.” She said that the same could be said about real-estate allocations, but private equity allocations are less under their control. “If prices are rich, we are going to be sellers and we are going to be way off of our asset allocation by the end of the year. I'm not predicting that that’s going to happen, but I’m also pushing us to be capturing the market opportunities when they are there.”

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