Business

Harvard Called 'Lazy, Fat, Stupid' in Endowment Report Last Year

By Michael McDonald
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- Consultants hear complaints about 'easy-to-beat' bonus targets
- Top 11 managers collected $242 million in pay over five years

Ivy League Fortune: Harvard's Highest-Paid Money Managers

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QuickTake University

Harvard University's money managers collected tens of millions in bonuses by exceeding "easy-to-beat" investment goals even as the college's endowment languished, employees complained in an internal review.

The consulting firm McKinsey & Co., in a wide-ranging examination, zeroed in on the endowment's benchmarks, or investment targets. Some of those surveyed said Harvard allowed a kind of grade inflation when it came to evaluating its money managers.

"This is the only place I've seen where people can negotiate the benchmark they get compensated on," read a "representative quote" in the McKinsey report.

The McKinsey assessment offered an explanation of what it called the "performance paradox" at Harvard's $35.7 billion endowment, the largest in higher education. Year after year, Harvard would report benchmark-beating performance while falling further behind rivals such as Yale, Princeton, Columbia and the Massachusetts Institute of Technology.

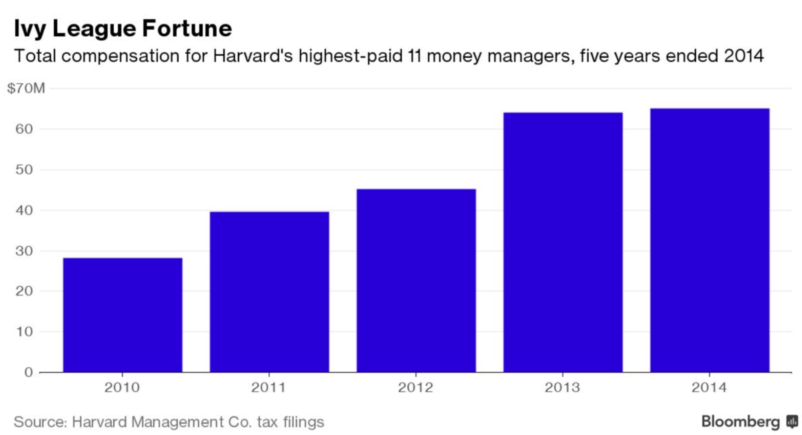
The April 2015 report, which has never been made public, spells out why the fund paid more than peers for lagging performance, as well as its management's strategy for shifting course. Harvard said it has since revamped its compensation.

Soaring Pay

McKinsey's review took a rare, unvarnished look into the culture of a secretive organization, where employees and others complained to McKinsey of an inattentive board and complacent culture -- in their words, "stable, rather than smart, capital" or, less charitably, "lazy, fat and stupid."

As Harvard's Cambridge, Massachusetts campus braces for possible budget cuts after a recent decline in the endowment, McKinsey's conclusions are likely to raise concern. For years, faculty and alumni have complained about money manager pay, which they have called inappropriate for a nonprofit.

The consultant's report focused on the five years ended June 2014, a period when manager compensation soared. During that half-decade, Harvard paid 11 money managers a total of $242 million, 90 percent of which was made up of bonuses, tax filings show. In the final year, total compensation amounted to $65 million, more than twice the amount five years earlier.



Harvard's endowment has "redesigned its compensation to further align the interest of investment professionals with those of the university," spokeswoman Emily Guadagnoli said in an e-mail. Because of under-performance in the most recent year, "current and former employees will forfeit compensation that was held back in prior years."

The new plan ties pay to "appropriate industry benchmarks" and a "significant portion" is held back and won't be awarded for performance that isn't sustained, she said.

In the report, the consultants cited a "representative" quote from within the endowment stating that benchmarks are "easy to beat, inconsistent and often manipulated." McKinsey summed up this sentiment in a PowerPoint slide: "The benchmarks are considered 'slow rabbits.'"

People familiar with the report said some at Harvard considered McKinsey's comparisons unfair because each school had such a different mix of investments and risks. They also took issue with the idea that benchmarks were manipulated.

Then Chief Executive Officer Jane Mendillo, who oversaw the endowment during the period McKinsey studied, had a goal of making the endowment less volatile after steep losses during the 2008 financial crisis. Even adjusted for risk, however, Harvard's performance lagged, McKinsey said. Mendillo declined to comment.

Key Targets

Universities and other organizations with money managers must strike a balance when setting performance targets, according to Ashby Monk, who directs a Stanford University research center and is a senior adviser to the University of California endowment. Setting goals too high encourages excessive risk, while setting them too low results in overpaying money managers, he said.

"You've got to get the benchmarks right," Monk said.

Harvard commissioned the study after it promoted Stephen Blyth, a former Deutsche Bank AG bond trader from head of public markets to chief executive officer in 2014. McKinsey delivered a 78-page PowerPoint presentation, which was reviewed by Bloomberg, to executives and money managers.

Afterward, Blyth overhauled Harvard's compensation and benchmarks, making targets harder to beat. Blyth stepped down in July after taking a medical leave. In December Nirmal P. Narvekar, the top-performing endowment manager from Columbia, will take over at Harvard. He will become the eighth permanent or interim chief executive since 2005.

Foregone Billions

In the five years scrutinized by McKinsey, the fund reported an average annual return of 11.2 percent, compared with Princeton's 14 percent, Yale's 13.5 percent and MIT's 13.2 percent. Harvard's relative under-performance cost the school $3.5 billion. Because of such results, McKinsey warned that Harvard could lose its perch as the world's largest endowment to Yale within 20 years. On a 10-year basis, Harvard's performance was "slightly better," McKinsey said.

U.S. Colleges Amass Riches as Students Sink in Debt: QuickTake

The review focused on what endowments call a "policy portfolio." It reflects the mix of each kind of asset a school owns -- from stocks and bonds to South American timberland. The university picks benchmarks, such as an equity index, to evaluate the performance of the different investments.

Over the five-year period, Harvard reported that its 11.2 percent average annual return beat its benchmarks -- its so-called policy portfolio -- by 1 percentage point, a significant margin for a money manager.

Then, McKinsey compared the college's performance to Stanford's policy portfolio, which it viewed as more ambitious. Had it been measured by the more rigorous standard, Harvard would have underperformed by half a percentage point.

Side Deals

In fact, merely running a portfolio of index-tracking funds -- 65 percent in the S&P 500 Index and 35 percent in a government bond index -- would have generated a 14.2 percent annual return.

During the financial crisis, managers took steps to move out poorly performing investments and adjust benchmarks, muddying performance judgments, according to one of the quotations from the survey: "There were so many side deals cut during the crisis - bad stuff moved out of portfolios and benchmarks adjusted - individual performance bears little resemblance to fund performance and we somehow seem OK with that."

The McKinsey report singled out alternative investments such as real estate and natural resources. They make up more than half of Harvard's portfolio, and McKinsey noted they performed strongly. At the same time, they were judged on benchmarks -- particularly for natural resources -- that were "less aggressive" compared with those at Yale, Princeton and Stanford, according to the report.

Highest Pay

In the five-year period, the university paid Andrew Wiltshire, who oversaw alternative investments, a total of $38 million, more than anyone else. Alvaro Aguirre, who oversaw holdings in natural resources like farmland and timber, made $25 million during the four years for which his compensation was disclosed. Wiltshire, who declined to comment, and Aguirre, who didn't return messages, both left Harvard last year.

During the entire five years, Harvard paid then CEO Mendillo $37 million, twice as much as top-performing David Swensen at Yale University.

The report recommended expanding Harvard's internal trading operations, which it said had an annual cost of almost $75 million, including performance bonuses for employees. Harvard did so, but later backtracked, eliminating at least a dozen positions.

Thanking Klarman

Blyth, who headed public markets, including the trading operation, was paid a total of $34 million over the five years. McKinsey found that Blyth's unit contribute strongly to the fund's performance, and its benchmarks fell in line with the school's peers. Blyth didn't return messages.

The report also noted that some of the best-performing investments in the portfolio were picked years ago. They included Baupost Group LLC, the hedge fund run by Seth Klarman, stock-picking hedge fund Adage Capital Management, and venture firm Sequoia Capital, an early backer of Google and PayPal Holdings Inc. "Thank God for Seth Klarman," one employee told the consultants.

McKinsey cited interviews describing recent commitments to strongly performing investments, such as Baker Brothers Advisors, a biotechnology stock-focused fund, as "incremental, scattershot and lacking in conviction."

Consultants heard complaints about the board overseeing Harvard Management Co., the school's investment arm: "The board doesn't ask the hard, searching questions around benchmarks and compensation."

Falling Behind

James Rothenberg, chairman of Capital Research & Management Co., the Los Angeles mutual-fund manager, chaired the board during this period. Rothenberg, who was also Harvard's treasurer, died in July 2015.

Paul Finnegan, founder of a private equity fund, joined the board in 2014 and succeeded Rothenberg as chairman last year. Most of the current members of the board joined in the last two years. Harvard President Drew Faust was also on the board during the period and remains a member.

McKinsey said staffers were proud to work for such a prestigious college, which they said could use its name to attract talent and gain access to investments. As one of those interviewed told the consultant: "Harvard shouldn't stand for mediocrity, but that's where we're heading if this continues."

Watch Next: Goldman's Lloyd Blankfein Says He's Surprised He Got Into Harvard