Harvard's New Endowment Manager Shakes Things Up After Dismal Performance

The new CEO of Harvard Management Company (HMC), N.P. "Narv" Narvekar, fired half of his staff last December, and in a letter announcing the moves, stated:

> Major change is never easy and will require an extended period of time to bear fruit. Transitioning away from practices that have been ingrained in HMC's culture for decades will no doubt be challenging at times.
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> But we must evolve to be successful, and we must withstand the associated growing pains to achieve our goals.

To each of those approximately 115 staffers who were let go, Narv offered his condolences: "It is exceptionally difficult to see such a large number of our colleagues leave the firm, and we will be very supportive of these individuals in their transition. We are grateful for their committed service to Harvard and wish them the very best in their future endeavors."

Narvekar is the eighth permanent or interim chief executive at the helm of HMC as returns from its $35 billion endowment continue to underperform not only the stock market in general but its peers at Yale, Columbia, and other Ivy League schools, as well.

The company's performance was so bad that consulting firm McKinsey & Company was brought in to find out what the matter was and to recommend changes. According to Bloomberg, which had a look at the report that wasn't made public, employees at HMC complained of an "inattentive board" and a "complacent culture," calling upper management "lazy, fat and stupid."

McKinsey found that during the five years from 2000 to 2014, the compensation for individual account managers soared while the fund's performance languished. Eleven money managers for HMC raked in $242 million, 90 percent of which was made up of bonuses for outperforming their "benchmarks." One of the authors of the report said, "This is the only place I've seen where people can negotiate the benchmark they get compensated on!" As a result, said McKinsey, those benchmarks were "easy to beat, inconsistent and often manipulated."

According to Bloomberg the performance failure cost the school's endowment $3.5 billion. In other words, the fund, worth about $35 billion today, should be worth closer to $40 billion, perhaps even more.

Narvekar has brought in some of his friends to help manage the fund, three of them from Columbia, where he managed that school's endowment to above-average performance. He has ordered the trading department to close its accounts, and announced plans to ship much of the fund's assets to outside hedge fund managers. Narvekar is being paid $9 million a year to manage the transition, with a three-year guarantee, much like in professional football. Even if he fails to perform he still gets the guarantee.

It's likely that Narvekar doesn't own any shares in Berkshire Hathaway, the gigantic investment fund owned and operated by Warren Buffett and his partner, Charley Unger. If he did, he would have read what Buffett thinks of those "outside" hedge fund managers in his latest shareholder newsletter. The answer, in two words, is: not much.

Narv would first of all have noted that BH shares gained 23.4 percent last year compared to HMC's fund which lost 2 percent, dropping its value below the $36.9 billion "high water" mark that it reached back in 2008.

Second, he would have learned that Buffett is about to collect on a bet he made nine years ago that the best hedge fund managers — even the very best-of-the-best — would underperform a simple buy-and-hold strategy of stocks invested in the Standard & Poor's 500 Index (ticker symbol SPX). As Buffett explained:

> Now, to my bet and its history. In Berkshire's 2005 annual report, I argued that active investment management by professionals — in aggregate — would over a period of years underperform the returns achieved by rank amateurs who simply sat still. I explained that the massive fees levied by a variety of "helpers" would leave their clients — again in aggregate — worse off than if the amateurs simply invested in an unmanaged low-cost index fund.

Initially he offered to wager $500,000 that no investment professional could select a group of at least five hedge funds that would, over a period of time, beat the returns on an unmanaged S&P 500 Index fund charging only token fees. Wrote Buffett:

> What followed was the sound of silence. Though there are thousands of professional investment managers who have amassed staggering fortunes by touting their stock-selecting prowess, only one man — Ted Seides — stepped up to my challenge….
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> Ted picked five funds-of-funds whose results were to be averaged and compared against my Vanguard S&P index fund. The five he selected had invested their money in more than 100 hedge funds, which meant that the overall performance of the funds-of-funds would not be distorted by the good or poor results of a single manager.

There were fees galore, fees upon fees, all designed, it is said, to "incentivize" the managers:

> Each fund-of-funds, of course, operated with a layer of fees that sat above the fees charged by the hedge funds in which it had invested. In this doubling-up arrangement, the larger fees were levied by the underlying hedge funds; each of the fund-of-funds imposed an additional fee for its presumed skills in selecting hedge-fund managers.

The results? From the start of 2008 the best of the five funds that Seides selected returned, through 2016, 62.8 percent. The worst returned just 2.9 percent.

And Buffett's S&P 500 index fund of choice — the Vanguard S&P index fund? It returned 85.4 percent.

Buffett was gracious to a fault:

> I'm certain that in almost all cases the managers at both levels were honest and intelligent people. But the results for their investors were dismal — really dismal. And, alas, the huge fixed fees charged by all of the funds and funds-of-funds involved — fees that were totally unwarranted by performance — were such that their managers were showered with compensation over the nine years that have passed. As Gordon Gekko might have put it: "Fees never sleep."

Buffett explained how those fees worked: rewarding performance in good years to such an extent that the overall performance of the fund was severely limited:

> We're not through with fees. Remember, there were the fund-of-funds managers to be fed as well. These managers received an additional fixed amount that was usually set at 1% of assets. Then,

> despite the terrible overall record of the five funds-of-funds, some experienced a few good years and collected "performance" fees. Consequently, I estimate that over the nine-year period roughly 60% — gulp! — of all gains achieved by the five funds-of-funds were diverted to the two levels of managers. That was their misbegotten reward for accomplishing something far short of what their many hundreds of limited partners could have effortlessly — and with virtually no cost — achieved on their own.

Concluded Buffett:

> A number of smart people are involved in running hedge funds. But to a great extent their efforts are self-neutralizing, and their IQ will not overcome the costs they impose on investors. Investors, on average and over time, will do better with a low-cost index fund than with a group of funds of funds.

It's unfortunate that "Narv" hasn't read Buffett's shareholder letter, or, if he has, he's not taking Buffett's advice. This is likely to mean that the investment performance of Harvard's endowment will continue to feed its managers, and himself, while leaving billions of potential dollars behind.

If Harvard weren't such a primary source for graduating individuals with a collectivist mindset and worldview who then successfully insinuate themselves into the body politic, it would be easy to grieve over its likely poor future performance.

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