The “New Normal”

Following what she called an “unusually challenging year” dominated by financial reversals, President Drew Faust delivered an “opening-of-year” address in Sanders Theatre on September 24, in lieu of the e-mail messages sent in prior years. It seemed “a good moment to talk in person,” she told the audience.

Economic conditions aside, the formal speech perhaps also symbolized an evolution in her leadership. In a conversation earlier that week, Faust said that the first two years of her presidency were deliberately characterized by consensus-building, dispersed authority, and listening. Now, atop that foundation for eliciting ideas and setting directions for the University—and in light of more straitened circumstances—she felt it necessary to display a “more assertive leadership,” defining and articulating those directions. Accordingly, her speech set out to describe those constraints, to recall universities’ distinctive mission, and to exhort members of the Harvard community to collaborate in all ways, so that “even as we find ways to adjust, we will also find ways to advance.” (The text and audio and video recordings are accessible at http://harvardmag.com/2009-state-of-harvard.)

Before focusing on “our changed financial situation” and the “difficult challenges” that still face the University, Faust recalled the “resilience” and “creativity” of prior Harvard generations in sustaining the world’s economies. We have reset the building blocks for a solid, innovative, and sustainable investment strategy.

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her expectation of “prolonged” slower growth in “some markets”—Mendillo cautioned about the need to be “realistic about near-term returns and about our expectations for several years to come.”

There is no indication that HMC is backing away from its expectation of long-term returns of 8.25 percent for a pool of assets diversified in line with the policy portfolio. Even including the losses just realized, HMC’s 10-year, annualized return on investments is now 8.9 percent—significantly above both conventional stock/bond portfolio performance (1.4 percent) and median large endowment returns (3.2 percent) during the same period. (Yale’s 10-year rate of return is now 11.8 percent, Princeton’s 9.7 percent.)

But Mendillo noted, “For Harvard, as for almost every investor, regaining the market value lost as a result of the recent global economic crisis will take time.” (If distributions to support University operations in the next few years approach 5.5 percent of the endowment’s value, as they may, and investment returns are below the long-term goal, the endowment’s value could remain essentially flat, excluding any capital gifts. Given the goal of exceeding inflation over time, such results for an extended period would be worrisome.)

Having weathered a punishing first year at HMC’s helm, Mendillo signaled two strategic shifts for the longer term. First, she characterized past changes in the policy portfolio as “incremental,” and suggested that a broader “rethinking” was under way, “to better suit current realities and lessons learned,” with “[f]ewer distinctions among the finely tuned asset classes to encourage greater collaboration among our teams in exploring investment themes.” Those are likely, however, to include still greater concentration “in areas where HMC has unique competitive strengths,” such as active fixed-income management, natural resources, real estate, and private equity.

Second, she stressed the lower costs and especially the advantages of better control and feel for the market realized through internal money-management expertise (HMC personnel manage about 30 percent of the portfolio now, down from 70 percent early in the decade). As a result, without setting a specific target for internal versus external management, she wrote, “[w]e are looking to increase the share of internally managed assets under the right conditions.”

With appropriate liquidity, new strategies, and several new people in place, Mendillo concluded, she and her colleagues have “positioned both HMC and the Harvard portfolio to be robust, steady, and, importantly, poised to benefit from growth in the world’s economies. We have reset the building blocks for a solid, innovative, and sustainable investment strategy.”
economic problems, climate change, infectious diseases and healthcare disparities, inequality, and religious and cultural strife. In conducting research, devising policy solutions, and education, she said, universities are uniquely placed to “take the long view” of immediate problems, placing them in historical context and maintaining a perspective on the horizon beyond. People within the University, she said, have the obligation “not just to serve but to doubt,” particularly at a time when “our work here has never mattered more.”

Turning to current circumstances, Faust noted that the endowment’s value had declined sharply (see “$11 Billion Less,” page 50). Given typical distributions of about 5 percent of the assets’ value annually, she noted that the decline would imply a loss of $500 million in such income—devastating for a University that derives more than a third of its operating revenue from that source. Instead, Harvard aims to spend about 6 percent this year, and then a progressively lessening percentage in future years, to keep the decline in operating revenues from being too abrupt or jarring. Nonetheless, that means that after a period of rapid growth, the University now faces a structural revenue gap, Faust said—because it tied income too closely to volatile markets and learned “costly lessons about risk” as a result.

Looking ahead (and outlining some of the information to be disclosed in Harvard’s annual financial report in October; check www.harvardmagazine.com for updates), Faust said that net income from tuition (after financial aid) declined in fiscal year 2009; that current-use giving had risen, but that gift income overall, as reported, had declined by nearly 10 percent; and that sponsored-research funding had risen by a relatively robust 7 percent. The latter boost may not be permanent, she warned, given the two-year surge of funding associated with the federal government’s stimulus program.

How would Harvard adapt? Faust reiterated principal elements in the financial plan (see “Finding a New Footing,” September-October, page 44): distributions from the endowment will decline 8 percent in the current fiscal year, and “at least” that much more next year. She said that the schools’ responses to new budgetary realities varied with their circumstances, but did not...
provide any detailed examples. Spending reductions did achieve “meaningful savings” last year, compared to the budget adopted before the financial crisis. Many reductions reflect multiple steps taken to restrain personnel costs: trims in hiring and in filling vacancies; some voluntary retirement incentives for staff, followed by layoffs last spring; and the freeze on faculty and nonunion staff salaries.

The University has also “slowed our ambitious capital plans,” she noted, especially with regard to the long-term ambitions in Allston. Compared to last year’s original capital plan, spending has been cut in half for the next several years, she said. And efforts continue to secure efficiencies in procurement.

For the future, Faust said, Harvard must identify and protect its core priorities—“what we’re here for,” namely “education and research of the very highest caliber.” It will not be possible to pursue every interesting idea, nor do everything done heretofore. The community, she said, would have to move promptly to a “new normal” state of affairs, because it was unlikely that rebounding financial markets would restore the endowment anytime soon. Accordingly, everyone at the University would have to “embrace the opportunity, and the necessity” of working more efficiently and cooperatively, doing better work by harnessing “the power of a more unified Harvard.” She invoked President Charles William Eliot, who in 1908 (his fortieth and last academic year in office) called for a “more collaborative, more integrated” University.

At the same time, Faust underscored Harvard’s commitment to attracting and supporting the best faculty members and students from around the world, a basic principle of both meritocracy and of access. She listed areas of intellectual connection across schools—ranging from the global economy and stem-cell science to work on human rights—and expressed hope that students and faculty members would increasingly feel themselves part not only of a single school, but of the University. She reiterated the commitment to liberal arts as a fundamental purpose of a Harvard education. And she encouraged members of the community to recognize their obligation to “live by the ethical standards we teach” and to “repay the privilege of being in a rare place like this” through lives of service.

Faust then sketched examples of the kinds of collaborations she encourages, both administrative and academic. She cited the task force examining the “curious practices” of Harvard’s 70-plus libraries, whose separate operations may impede access to collections and produce duplication, unaffordable expense, and suboptimal teaching and research. Separate information-technology systems around the University, she added, likewise impede compatibility and collaboration, and drive up costs.

On the academic side, she said the new undergraduate General Education curriculum, just launched with novel courses, “invites our faculty to join intellectual forces and our students to trespass” across intellectual boundaries—not only within the Faculty of Arts and Sciences (FAS) but across most of the professional schools. Similarly, she said, 200-plus faculty members had joined forces to plan initiatives in global health, resulting in new research clusters (on chronic diseases, children’s health, and new technologies), yielding new interfaculty courses, and “modeling a culture of collaboration.”

Whatever the value of the endowment, Faust emphasized, “there is a wealth of intellectual opportunity within this University.” Some of the opportunities reside within disciplines, but others exist across such boundaries, so “We need one another to do our best work.”

Though a “start of year” address may appropriately skip details, very hard tasks still loom before the University: it will take effort and good will to keep everyone pulling together. Among Harvard units, FAS remains particularly stressed fiscally (see page 58). As major assumptions about campus development in Allston are comprehensively revised—the most sweeping visions included relocating entire schools and building vast new laboratories—there will be significant issues to explore, including the nature of collaborations with prospective partners (nonprofit or commercial) and conceiving a feasible new financial strategy. In the meantime, Harvard must weigh renovation of those schools’ existing facilities, even as it adjusts community-planning efforts with residents of Allston. Internally, should Harvard’s myriad information systems be melded, outsourced, or reconfigured in other ways? And so on.

In making such decisions, fundamental or seemingly mundane, Faust made it clear in her conclusion that her approach to Harvard’s challenges was anchored in her own deepest professional commitment—as an historian whose works include the acclaimed Mothers of Invention (on Southern women in the American Civil War). If the community proceeds in the cooperative spirit she summoned, Faust said, Harvard will emerge from its current situation “as an even stronger and more vital” institution. “If we do,” she said, “we may someday look back on our current financial necessities as our mother of invention.”