

PHILLIPS READING ROOM, WIDENER LIBRARY

Focusing attention on undergraduate education, Harvard has initiated a number of curricular changes and is poised to review all aspects of the undergraduate academic experience. The ongoing renovation of Widener, the main

undergraduate library, is improving study spaces and functionality while expanding access to materials.

To the Members of the Harvard Community:

I am pleased to have the opportunity to convey to you Harvard University's fiscal 2002 annual financial report. Despite the extraordinary circumstances of the past year, I can certify that Harvard University remains in sound financial health. The report on the following pages will describe in detail the various aspects of our financial picture, including:

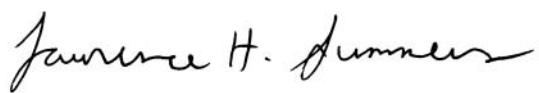
- ❖ a \$70 million operating surplus on \$2.3 billion of expenses,
- ❖ an endowment that ended the year with a total investment return of negative 0.5%, an exceptional result in light of the past year's economic environment, and
- ❖ the continuing generosity of our supporters, who contributed \$477 million to help further our mission.

During my first year as President, we took the opportunity to look anew at some of Harvard's financial procedures to make sure we are making the most of our resources. Provost Steve Hyman actively engaged each faculty in an effort aimed at strengthening their budgeting and academic planning processes. Along with an outside management consulting firm, we undertook a review of certain central University functions to ensure we are maximizing the resources available to support our mission. We also continued to examine our business practices in order to further streamline our administrative processes and procedures, resulting in a number of process improvements.

Our challenge for the years ahead will be to continue to be responsible stewards of the resources at our disposal while directing their use to our most important priorities. These include reinvigorating the undergraduate experience, facilitating leading-edge science research and education, expanding financial aid for graduate students, and developing our property in Allston in a way that will enhance Harvard's role as a leader in teaching and research.

Each of these opportunities will require the commitment of substantial new resources, as well as prudent fiscal management. I look forward to working with all of you to take advantage of these opportunities and to ensure a robust and vibrant future for our university.

Sincerely,

A handwritten signature in black ink that reads "Lawrence H. Summers". The signature is written in a cursive, flowing style.

Lawrence H. Summers
PRESIDENT

October 7, 2002

To the Board of Overseers of Harvard College:

The past year was one marked by change. Shortly after Lawrence Summers began his Harvard presidency, our sense of peace and stability was shaken by unprecedented world events. President Summers responded to the tragedy of September 11 by challenging all of us at Harvard to educate ourselves, to seek understanding, and to work toward finding solutions to our common problems. Despite great uncertainty in the economy and in the world, the Harvard community is responding to President Summers' challenge by refocusing our priorities and programs and by beginning to redirect our resources. In his introductory letter to this report, President Summers has underscored the importance of the strong financial management needed to secure the resources essential to meeting the University's priorities. As this year's financial report demonstrates, Harvard remains in sound financial condition, well positioned to meet the challenges that our future holds.

The financial results for fiscal year 2002 are presented in detail in the following pages. We would like to take this opportunity to discuss the major points.

FINANCIAL HIGHLIGHTS

- ❖ Fiscal year 2002 was a relatively good year financially. Considering the economic environment, the Harvard Management Company had an exceptional year, ending with a negative 0.5% total return. Total market value of the endowment dropped from \$18.3 billion to \$17.5 billion, primarily as a result of the endowment payout. Total net assets declined slightly from \$21.9 billion to \$21.3 billion.
- ❖ The University ended the year with a total operating surplus of \$70 million on \$2.3 billion of expenses. Restricted funds, whose use is limited in future years to the purposes designated by the donors or sponsors, generated all but \$1 million of the operating surplus.

- ❖ Harvard raised more than \$477 million through the continued generous support of alumni and friends. Endowment gifts totaled \$207 million, current use gifts were \$132 million, and the remaining \$138 million included grants for research as well as gifts for loans, facilities, and life income funds.

- ❖ Sponsored funding for research and training rose 3% overall. More significant, however, was the 13% increase in funding from the federal government, our largest and most stable source of sponsored support. Support from non-federal sources was less than in fiscal year 2001 due to the receipt of several extraordinary grants in that period.

- ❖ Endowment income distributed for operations increased by 22% to \$749 million, a result of the 21% increase in the distribution rate. The distribution rate is set by the Corporation seven months before the beginning of the fiscal year to enable the Schools to prepare their budgets. The substantial increase in the fiscal year 2002 rate was determined at a time when the spending rate had dropped to 3.3% of endowment market value. The increase in the payout, when combined with the decline in the economy, resulted in a 4.8% spending rate in fiscal year 2002, well within our targeted spending rate range.

Endowment income distributed for operations is now Harvard's largest source of income, constituting 32% of total income. Just 10 years ago, the endowment supported only 19% of total income. The activities endowed over time by our alumni and friends have benefited enormously over the past decade from both robust capital markets and the strong performance of the Harvard Management Company.

- ❖ Student income, net of scholarships applied to tuition and fees, rose by only 0.6%. Income from executive and continuing education programs actually declined by 2.6%, largely due to the weak economy and the aftermath of September 11.

- ❖ Total expenses grew by 11%. The increase was due in part to costs related to recent acquisitions—the Harvard Institutes of Medicine building, the Watertown Arsenal, and property in Allston. The increase is also directly related to the 22% growth in endowment distributions and 13% growth in federally sponsored research income. These funds are being used to support new research, new educational opportunities, incremental student aid, and new programs.

- ❖ The University spent over \$1.1 billion on compensation, an increase of 11% over the previous year. Total compensation growth included merit increases, equity adjustments, a rise in student employment, a 5% increase in faculty and other teaching appointments, and 4% growth in administrative, technical, and research staff. Benefits increased by 17%, largely driven by rising health costs and a change in our pension plan.

- ❖ Space and occupancy expenses increased by 19%, in part due to the acquisitions noted above. In addition, as in recent years, the University rented more space, including accommodations for the Medical School in Kendall Square and in Boston as well as for the Law School in Cambridge. Harvard spent a total of \$460 million on physical renewal, new facilities, and acquisitions. The most significant projects included renovations to Widener Library and construction on the Bauer Life Sciences Building, Hawes Hall, and the new research building in the Medical Area.

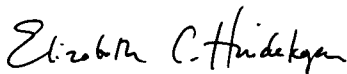
- ❖ Finally, total scholarships and other student awards grew by 15% overall, an extraordinary improvement for our students.

A FINANCIAL REPORTING CHANGE

The Financial Accounting Standards Board recently reconfirmed and clarified certain accounting standards that require entities to report gross assets and liabilities associated with certain institutional investments on their balance sheets. In previous years, Harvard reported the assets of the investment portfolio net of related liabilities

as a single line item on our balance sheet and provided full disclosure of the gross assets and liabilities in *Note 14*. In this year's financial report, we have presented the gross investment assets, as well as the related liabilities, directly on the balance sheet. This presentation results in much larger assets and liabilities totals than readers of this report have seen in the past. The net assets, however, are unaffected. For more detail on this presentation, see *A Note on Financial Reporting* on page 10 and the *Supplemental Information on Pooled General Investments* on page 56.

During their first year in office, President Summers and Provost Steven Hyman immersed themselves in learning about Harvard's human, capital, and programmatic resources. They also gained understanding of the opportunities that Harvard is in a position to consider—opportunities to make significant improvements to our educational programs and to contribute to the world through research, training, and public service. Over the next few years, the President and Provost will be working with the deans and the entire Harvard community to focus our resources on meeting the challenges that these opportunities present.



Elizabeth C. Huidekoper
VICE PRESIDENT FOR FINANCE



D. Ronald Daniel
TREASURER

October 7, 2002





GUND HALL, GRADUATE SCHOOL OF DESIGN

Harvard has completed a study of the financial challenges facing students and recent alumni of its graduate and professional schools. The results are guiding the development of a pilot program aimed at

helping future graduate students in a variety of ways, including debt reduction.

Analysis of financial results

Harvard ended fiscal year 2002 in solid financial condition, with a strong endowment, net assets of \$21.3 billion, and both restricted and unrestricted operating surpluses.

OVERVIEW

In fiscal year 2002, while experiencing great internal and external change, Harvard maintained financial strength. The University ended the year with an unrestricted operating surplus of \$1.2 million and a restricted operating surplus of \$69.2 million on total revenue of \$2.4 billion. The primary source of these surpluses was a 22% increase in endowment income distributed.

Harvard's assets at year-end totaled \$43.9 billion, and liabilities totaled \$22.6 billion. Net assets of \$21.3 billion included \$17.5 billion of endowment. In addition to endowment principal, this endowment total includes \$348.3 million of endowment pledge balances and \$222.5 million of interests in perpetual trusts held by others.

A NOTE ON FINANCIAL REPORTING

The Financial Accounting Standards Board recently reconfirmed and clarified certain accounting standards that require entities to report gross assets and liabilities associated with certain institutional investments on their balance sheets. In previous years, Harvard reported the assets of the investment portfolio net of related liabilities as a single line item on the balance sheet, with full disclosure of the gross assets and liabilities provided in *Note 14*. In this year's financial report, the balance sheet displays both the assets and corresponding liabilities

generated by security lending transactions. These are transactions executed to support the investment activities of the Harvard Management Company. Harvard has also reported separately the fair value of assets for which the counterparty has the right to pledge or exchange the collateral it has received; assets of the investment portfolio that are unencumbered are reported as investments. This presentation

Harvard's many achievements over the past fiscal year extended from the areas of teaching and research to administration and public service. The highlights that follow provide a view of the accomplishments of each School and of the University as a whole.

A NOTE ON FINANCIAL REPORTING CONTINUED

results in much larger assets and liabilities totals than readers of this report have seen in the past. The net assets, however, are unaffected.

These financial transactions, while not unique to Harvard, are not commonly found on the balance sheet of many educational institutions. Because Harvard directly oversees certain of its investments, these transactions must be reflected on Harvard's balance sheet. Where an institution

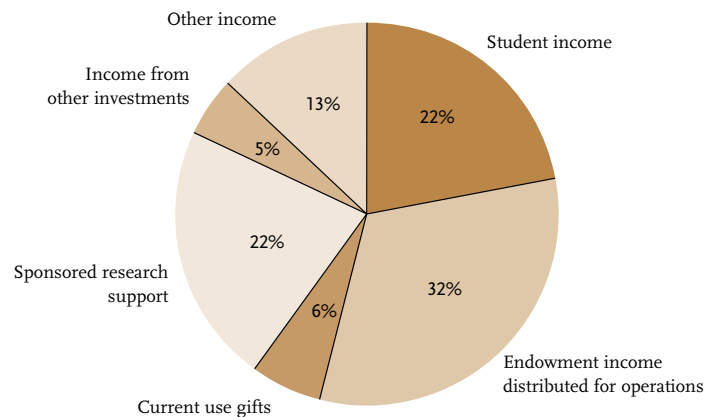
employs an outside investment firm, only the net investments are generally reflected on the balance sheet. For more detail on this presentation, see the *Supplemental Information on Pooled General Investments* on page 56.

FINANCIAL RESULTS

This section of the report analyzes revenue and expenses for fiscal year 2002. It is followed by reviews of endowment results and capital activities and a report on the fiscal 2002 performance of the Harvard Management Company (HMC), which includes a description of HMC's investment policies.

REVENUE Total operating revenue in fiscal year 2002 was \$2.4 billion. The principal sources of this revenue were student income, income from the endowment distribution, income from other investments, sponsored research support, and current use gifts. A variety of sources, many of which are connected to specific auxiliary activities, provided the balance of operating income.

FISCAL YEAR 2002 OPERATING REVENUE



FACULTY OF ARTS AND SCIENCES

William C. Kirby, Geisinger Professor of History and Director of the Asia Center, was named Dean of the Faculty of Arts and Sciences. In admissions, another record-breaking year underscored both the draw and the selectivity of Harvard College.

With 19,609 applicants, the admissions pool for the Class of 2006 was the largest ever. Only 10% of these applicants were admitted, the lowest percentage in Harvard's history. Nearly 80% of admitted students accepted Harvard's offer, a level

not seen in three decades. In line with the goal of dramatically expanding the freshmen seminar program, the College established an office to renew and develop freshmen seminar offerings. As a result, the number of seminars increased

from 35 to 61 in one year, and student applications for the spring term increased fourfold over the year before.



STUDENT INCOME In fiscal year 2002, the percentage increase in undergraduate tuition, room, board, and fees was 4%. Student income as a whole totaled \$509.5 million, an increase of only 1% over the prior year. Increases in undergraduate tuition (3%), graduate tuition (6%), and board and lodging revenue (5%) were offset by a 13% increase in scholarships applied to student income. Continuing and executive education programs were negatively

affected by both the economy and the events of September 11. Despite new and expanded offerings at the Kennedy School of Government, the School of Public Health, and the Law School, overall revenue from these programs decreased by 3%.

SUMMARY OF FINANCIAL RESULTS

Dollar amounts in millions

	1998	1999 ¹	2000	2001	2002
Total income	\$ 1,679.3	\$ 1,771.9	\$ 2,022.6	\$ 2,228.2	\$ 2,357.0
Total expenses	1,629.5	1,837.4	1,902.5	2,063.3	2,286.6
Total giving	466.1	460.2	505.0	707.1	477.5
Student notes receivable	225.6	198.0	172.9	159.0	151.3
Fixed assets at net historical cost	1,654.2	1,651.0	1,841.2 ²	2,382.8	2,774.4
Bonds and notes payable	1,142.4	1,168.0	1,276.4	1,622.2	1,839.5
General operating account, net assets	2,382.7	2,751.6	3,186.0	3,279.9	3,419.9
Endowment funds, net assets	13,278.9	14,755.6	19,148.3	18,259.2	17,518.0
Total return on general investments	20.5%	12.2%	32.2%	(2.7%)	(0.5%)
Degree student enrollment	18,513	18,569	18,541	18,847	19,539

¹These numbers are restated to include Radcliffe.

²This number is restated to conform with fiscal year 2001 presentation.



BUSINESS SCHOOL

A new research center in Paris and satellite office in Tokyo were opened as part of the School's ongoing creation of a global network to develop research insights and educational materials that will better prepare business leaders to face the challenges of the

rapidly evolving world economy. Locally, a new, technologically enhanced MBA classroom building was completed, and extensive planning for a major renovation to Baker Library, including the addition of a new academic center, was begun.



SCHOOL OF DENTAL MEDICINE

HSDM began a comprehensive departmental reorganization, merging seven departments into five in order to create more synergies across the academic continuum—from basic science

through clinical application. The re-engineered departments allow an expanded integration of science and research with all patient care and clinical activities.

ENDOWMENT In fiscal year 2002, the Corporation increased the endowment distribution significantly in order to meet the targeted spending rate of 4.5% to 5% of the endowment's market value. Endowment income distributed for operations rose by 22% to \$749.0 million, compared with an 11% increase in fiscal 2001. The endowment and related spending policies are discussed in detail in the section of this report beginning on page 18.

SPONSORED RESEARCH SUPPORT Support for sponsored research grew 3% in fiscal year 2002 to a total of \$518.8 million. The leading source of Harvard's funding in this area remains the federal government, which in fiscal 2002 provided approximately 77% of total sponsored funding to the University—an increase of 13% over the prior year. Foundations provided 15% of sponsored support, and the remaining 8% came from sources including corporations, state and local governments, foreign governments, and research institutes.

Three of the University's Schools accounted for 94% of federally funded research support in fiscal 2002. The Medical School represented 41% of the total; the School of Public Health, 29%; and the Faculty of Arts and Sciences, 24%. Agencies of the Department of Health and Human Services, principally the National Institutes of Health (NIH), provided 77% of Harvard's federal support. This funding level, consistent with recent years, reflects

how the University has benefited greatly from NIH support over the past five years. In addition to NIH funding, Harvard received 8% of its federally sponsored research support from the National Science Foundation and 4% from Defense departments; the remainder was provided by entities including the Department of Energy, the Department of Education, and the National Aeronautics and Space Administration.

The University also has many non-federal sources of sponsored support. Due primarily to a number of extraordinary foundation and corporate grants received in fiscal 2001, Harvard experienced a 20% decrease in non-federal funding in fiscal 2002.

The indirect costs of research, such as facility operations, depreciation, debt service, library use, and administrative costs, are aggregated and allocated as overhead to the direct costs of sponsored projects. Income to reimburse indirect costs in fiscal 2002 was \$124.0 million, representing an 11% increase over fiscal 2001. There is currently a national trend of lowering indirect cost rates among private institutions. However, in federal indirect cost rate proposals submitted during fiscal 2002, Harvard demonstrated the need to maintain current rates in order to meet the substantial indirect costs of supporting federal research.



SCHOOL OF DESIGN

Key curricular developments included engagement in undergraduate education and a slight expansion in enrollment. In order to fill a need for study of the built environment in the undergraduate curriculum, the School's faculty developed a core course, two freshman seminars, and a tutorial

and also cross-listed several courses with the College. In graduate offerings, enrollments in two degree programs were increased in order to obtain economies of scale as well as the target enrollment for the programs.



DIVINITY SCHOOL

William A. Graham, Murray A. Albertson Professor of Middle Eastern Studies and Professor of the History of Religion, served as acting dean during the second half of the year and was subsequently named dean. The School completed a comprehensive

institutional self-study involving faculty, staff, and students in preparation for its decennial accreditation review. In addition, the highly successful expansion and renovation of Andover-Harvard Theological Library was finished.

Proposals were submitted to the Department of Health and Human Services for the University Area, the Medical School, and the School of Public Health (SPH). While the SPH proposal is still under review, University Area and Medical School rates have been agreed upon through fiscal year 2006.

GIFTS FOR CURRENT USE Gifts for current use from Harvard’s alumni and friends totaled \$132.2 million in fiscal 2002. This 17% decrease from fiscal 2001 is attributable to several factors. Volatility in the capital markets played a major role in this decrease, as did Harvard’s decision to institute a 60-day moratorium on fundraising following September 11. Finally, in fiscal 2001, the University had been the beneficiary of several large gifts, all of which were received in that fiscal year rather than being paid out over several years. Current use gifts in fiscal 2002, however, had tremendous and immediate impact on the University’s priorities. Notably, a major payment from a very large bequest is providing near-term support for the sciences. Another significant gift went to the discretionary fund of the President and Provost, supporting their efforts to establish and fund priorities.

OTHER INCOME Auxiliary enterprises consistent with Harvard’s mission provide the majority of revenue to the other income category, which rose slightly to \$333.8 million in fiscal 2002. Revenue from Harvard’s printing and publishing organizations continues to be the largest component of other income. Royalties, rental and parking fees, health and clinic fees, and ancillary sales and services are the other major contributors to this category.

EXPENSES In fiscal year 2002, Harvard’s total operating expenses were \$2.3 billion. This figure represents an 11% increase over fiscal 2001 expenses of \$2.1 billion.

FINANCIAL AID Financial aid is one of the most important means by which Harvard meets its objective of recruiting and educating the world’s most promising students for the next generation of leadership. The University is continuing to build on the strengths of its financial aid program for students at the College and at its graduate and professional schools. Much of this student aid is donated by generous Harvard alumni. The University is able to fund a substantial portion of financial aid through current use gifts and endowment income as well as through federal support.



SCHOOL OF EDUCATION

Ellen Condliffe Lagemann, a leading historian of education, was recruited from the presidency of the Spencer Foundation to be the School’s new dean. In an initiative to help HSGE attract and retain the very best

doctoral students, the President made a five-year commitment to the School to fund additional fellowship aid for incoming doctoral students. Further, renovations were completed on the Gutman Library’s

special collections space to make these resources more accessible to scholars.



JOHN F. KENNEDY SCHOOL OF GOVERNMENT

The applicant pool for the fall 2002 class at the Kennedy School was 32% larger than that of the prior year. For the first time, the majority of students who accepted offers were women. A record-high 42% of U.S.

students accepting admission to the Master of Public Policy program were people of color—a level of minority representation unprecedented at the Kennedy School and other prominent U.S. schools of public policy.

In order to put Harvard within reach of students from all economic backgrounds, the College is committed to the dual principles of need-blind admissions and need-based financial aid. To this end, over the past four years the College has increased its annual scholarship program for undergraduates by more than \$22 million, representing a 54% rise in need-based grant assistance. Approximately 70% of current undergraduate students receive some form of financial aid. The average undergraduate award package—composed of grants, loans, and employment—represents almost two-thirds of the total cost of attendance. For 46% of students, the aid includes institutionally funded, need-based grants.

Beyond providing need-based financial aid, the College is also committed to ensuring that students have access to the entire range of academic and extracurricular opportunities while at Harvard, and to all the career options that await them upon graduation. Over the past few years, significant enhancements to the financial aid program have made it possible for students to contribute to the cost of their education without carrying an undue burden of term-time work or debt after graduation. Through an initiative to meet individual needs with greater freedom and flexibility, students may now choose to work 12 hours per week during the academic year or to borrow just over \$3,000 annually to meet their expected contributions. These policies

and financial aid enhancements are responsible for the pronounced decline in the average indebtedness among graduating seniors, from \$14,999 for the Class of 2000 to \$13,360 for the Class of 2001 to \$10,465 for the Class of 2002.

Financial aid also helps the University attract talented students to its graduate and professional schools; depending upon the program, anywhere from 50% to 90% of the students receive financial support. While grant aid for graduate students has increased, rising debt continues to be an issue. During fiscal year 2002, the University completed a study of financial challenges faced by students and recent graduates of its graduate and professional schools, which will translate to a pilot program to help incoming students in 2004 and beyond. This pilot program is intended to provide scholarship assistance designed to recruit and retain the highest quality doctoral students; to help reduce the debt burden for those students with career aspirations in public service; to contribute to scholarship funding for doctoral students in Interfaculty programs; and to support a loan program to promote access for students who may not otherwise have low-cost borrowing options. Assessment of need and consideration of funding for the pilot program will be undertaken in the coming fiscal year.



LAW SCHOOL

Following a period of extensive faculty discussion, the School restructured its curriculum into a “Law College” system that enhances the student experience during the first year. Section size was decreased from 140 to 80 students. The innovations also

included greater student-faculty interaction, ongoing feedback in required courses, intellectual and social section activities, and an expanded First Year Lawyering Program to integrate the study and actual practice of law.



MEDICAL SCHOOL

The School's research faculty brought in a 17% increase in federally sponsored revenue, including a \$40 million, five-year initiative to develop the nation's only molecular target laboratory. In support of research, HMS formed an Office of Research Compliance and recruited a national

expert from the National Institutes of Health to lead it. To further its educational mission, HMS launched The Academy, an initiative to provide additional financial support for teaching physicians and to focus on curriculum reform.

In fiscal year 2002, scholarships and student awards, including amounts applied directly against student income, increased 15% over fiscal 2001 to a total of \$215.0 million. In addition, Harvard loaned \$24.0 million to students and spent \$50.3 million on student employment. The University also acted as agent on behalf of specific student recipients for \$9.1 million in aid from outside sponsors.

Harvard's student loan programs are supported by federal funds, University capital resources, and donor-established loan funds. At the close of fiscal 2002, the University held \$151.3 million in outstanding loans to current and former students. This total is exclusive of loans made directly to students through the Federal Direct Student Loan Program and other non-Harvard sources. Harvard's use of the Federal Direct Student Loan Program for loans formerly financed with University funds is the reason for the ongoing decline in student notes receivable, a trend that will continue as Harvard-financed loans are repaid. In fiscal 2002, student notes receivable fell by \$7.7 million.

COMPENSATION To fulfill its educational mission, Harvard depends on the talent and commitment of its faculty and staff and strives to recruit and retain the most qualified people. A desirable compensation package gives Harvard an edge in competing with both peer institutions and employers

outside academia. Accordingly, the University offers an attractive array of benefits that includes pension plans, health benefits for active and retired employees, dental plans, and life insurance. Ancillary benefit programs range from tuition assistance to child and elder care resource services, discounted mortgage programs, tax-deferred annuity programs, and free admission to Harvard's museums and libraries.

Together, salaries, wages, and benefits reached \$1.1 billion in fiscal year 2002. This total compensation figure represents 49% of total University expenses, the same percentage as in the prior fiscal year. Compensation costs grew 11% during the year as a result of several factors. Part of the growth was attributable to salary increase programs for continuing faculty and staff. The University also began to implement the core recommendations of the Harvard Committee on Employment and Contracting Policies concerning compensation and employment practices for Harvard's lowest-paid workers. Additionally, there were staffing increases related to sponsored programs, faculty hiring initiatives, and work required to implement the University's new human resources systems. Finally, benefits costs increased because of rising health-care expenses and the execution of pension plan changes.



RADCLIFFE INSTITUTE FOR ADVANCED STUDY

The Institute hosted 43 fellows in fields ranging from physics to poetry. The quality of the class was reflected in its high selectivity, with only one in 20 applicants accepted. During the year, 33 fellows and faculty served as senior research partners for

38 undergraduates working on topics as varied as sea urchins and terrorism.



SCHOOL OF PUBLIC HEALTH

SPH was awarded more than \$45 million in sponsored funding to start or expand public health initiatives in Africa. One such effort is the collaboration of the Harvard AIDS Institute and the Botswana Ministry of Health to open a new laboratory in the capital

city. The laboratory will help combat AIDS in Botswana, the nation with the highest rates of AIDS infection in the world.



In addition to traditional compensation, each School at the University offers educational loans to faculty. Mortgage loan and subsidy programs exist to help new faculty members cope with the high cost of housing in the Boston area. Total loans outstanding to faculty under these programs increased to \$97.4 million in fiscal 2002 from \$84.0 million in the preceding year.

SUPPLIES AND EQUIPMENT In fiscal 2002, expenses for supplies and equipment rose 3% to \$200.9 million. Preferred vendor partnerships yielded \$20.0 million of savings off list prices. In particular, Harvard benefited from three major price cuts on scientific supplies and also received value-added services, such as free calibration of scientific instruments.

SPACE AND OCCUPANCY Costs related to acquisitions, together with more rental space, accounted for a 19% increase in space and occupancy costs in fiscal 2002. The year's total was \$205.3 million, compared with \$173.2 million in fiscal 2001. At the end of fiscal 2002, Harvard owned 20.2 million square feet of space. Recent growth in owned space has added to overall maintenance and security costs. Harvard's rental costs increased substantially, due both to expanded rental needs from growth in staff and programs and to the temporary relocations

caused by renovation of owned space. Utility costs grew 8% over the prior year, primarily due to an increase in electricity costs.

OTHER EXPENSES This category experienced an increase of 6% in fiscal 2002 to a total of \$525.9 million. University preferred vendor relationships yielded cost savings. Examples include an agreement with Harvard's temporary services vendor that allows the hiring of temporary workers as permanent employees at no cost and the retention of airline discounts in spite of decreased post-September 11 travel. The University also continued to consolidate vendors and leverage buying activity, exemplified by the negotiations for the procurement of printing services that are currently underway. Offsetting these savings were increased spending on sponsored projects as well as growth in endowment-supported activities. The largest items within other expenses in fiscal 2002 were purchased services, at \$265.1 million; publishing, \$55.1 million; research subcontracts to other institutions, \$69.0 million; travel, \$46.2 million; and telephone, \$13.0 million. Certain items in this category are unique to individual Schools, such as funds spent by the Medical School to reimburse its affiliated hospitals for the use of facilities and personnel.



THE UNIVERSITY

Harvard inaugurated Lawrence H. Summers as its 27th President. President Summers earned a Ph.D. in economics at Harvard and was one of the youngest full professors ever appointed by the University. He served as Secretary of the Treasury before taking up his new post.

Steven E. Hyman was appointed Harvard's Provost. A graduate of the Medical School, Provost Hyman was the original faculty director of Harvard's Interfaculty Initiative in Mind/Brain/Behavior and most recently served as Director of the National Institute of Mental Health.



Harvard supported its local community in a variety of ways. The Harvard Children's Initiative followed its successful ReadBoston campaign with WriteBoston, aimed at helping Boston middle school and high school students gain greater learning and life skills.

The Harvard After School Initiative provided \$400,000 in grant support to the after-school offerings of 21 programs serving Boston youth.

Review of endowment results

Harvard's endowment, which comprises approximately 10,300 separate funds, had a market value of \$17.5 billion at the end of fiscal year 2002.

A STRONG ENDOWMENT

The endowment is the financial cornerstone of Harvard's continued excellence in education and research. Active fundraising and prudent investment have helped secure the endowment, even in the face of an uncertain economy. While turmoil in the capital markets made large-gift fundraising a challenging endeavor, Harvard donors continued to be generous in supporting pressing needs, with

gifts to endowment totaling \$207.0 million in fiscal 2002. The past year also provided the opportunity to lay groundwork for new initiatives, including campaigns for the Business School and Law School.

REAL ENDOWMENT GROWTH

	Compound annual rate of growth			
	1974-83	1984-93	1994-02	1974-02
Total general investment return	12.0%	14.0%	15.4%	12.9%
Average per unit income distributed as a % of unit value	(5.2)	(4.2)	(4.1)	(4.5)
Total return reinvested	6.8	9.8	11.3	8.4
Capital additions	3.4	1.6	2.1	2.4
Total growth in endowment	10.2	11.4	13.4	10.8
Inflation rate	(8.2)	(3.7)	(2.5)	(4.8)
REAL ENDOWMENT GROWTH	2.0%	7.7%	10.9%	6.0%

PERFORMANCE OVERVIEW

Harvard Management Company (HMC) maintains responsibility for investment of the endowment. The following review of the endowment's performance in fiscal year 2002 is complemented by the *Annual Report of the Harvard Management Company*, beginning on page 24, which analyzes the year's performance in detail and discusses HMC's investment philosophy.

In fiscal 2002, total return on generally invested endowment was a negative 0.5%, compared with a negative 2.7% in fiscal 2001. During the fiscal year, the market value of the endowment decreased from \$18.3 billion to \$17.5 billion, primarily as a result of the endowment payout. Despite conditions in the capital markets, the endowment outperformed its benchmarks by 4% during this period. The change in market value includes all endowment

PERFORMANCE OVERVIEW CONTINUED

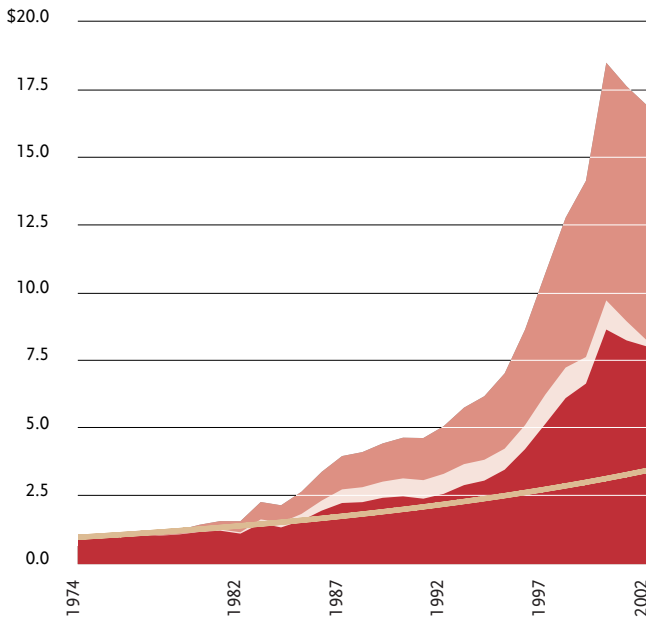
activity—appreciation or depreciation on investments, funds distributed to Schools and departments for operations, new gifts and pledges, additions to endowment made by departments from unrestricted balances and gift balances, and the deployment of endowment appreciation for specific purposes approved by the Corporation.

The University has an endowment spending policy that aims to maintain the purchasing power of the endowment while providing a reliable stream of income for operations. Accordingly, Harvard

seeks to distribute between 4.5% and 5% of the endowment’s market value annually, and since 1971 the average annual distribution has been 4.5%. Beginning in fiscal 1998, the Corporation approved larger increases in the distribution in order to achieve the desired spending rate. In fiscal year 2002, endowment distributions yielded a spending rate of 4.8%.

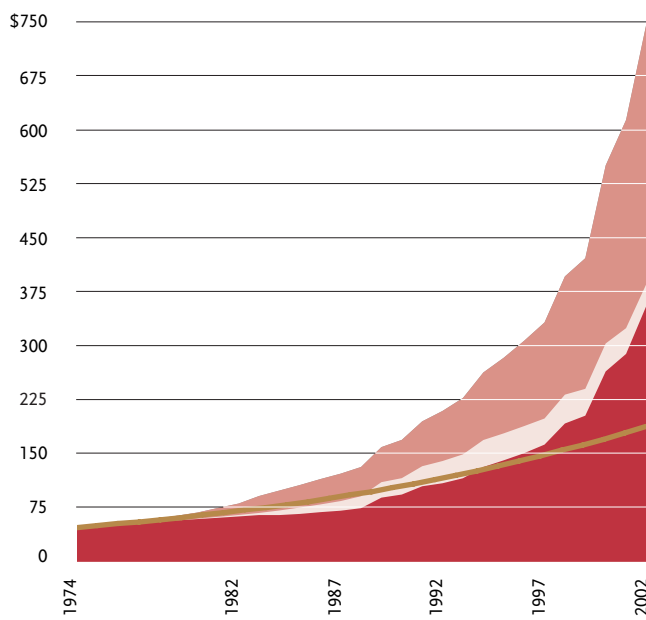
ENDOWMENT GROWTH*

In billions of dollars



ENDOWMENT INCOME DISTRIBUTED

In millions of dollars



■ 1974 Principal and appreciation ■ Capitalized income ■ Gifts and other changes — CPI growth

* To allow for comparability with years prior to fiscal year 1995, this chart does not include pledge balances and interests in perpetual trusts.

Review of capital activities

In fiscal year 2002, Harvard was engaged in approximately 400 active capital projects to expand and improve its physical plant, which currently includes 20.2 million square feet of space in more than 580 buildings as well as over 100 acres of land for development.

APPROACH TO CAPITAL ISSUES

Comprehensive planning is the primary strategic tool that Harvard uses to prepare for future growth in a manner that both addresses the University's space needs and considers the impact of growth on its neighbors. Following major acquisitions of land and buildings in the Allston section of Boston and in Watertown during the prior year, the planning process intensified in fiscal 2002, while the University continued to balance new construction with renovation and renewal.

The planning process for the Allston property came into sharper focus with the inauguration of President Summers. In November 2001, the new President reconstituted the University Committee on Physical Planning, which was enlarged to include more faculty members, representatives from the Medical Area, and community relations staff. The committee is spending its first year in an investigation of possible models for the Allston property. Advisory groups of committee members are exploring each of these models—a science campus, a graduate and professional school campus, and an arts and culture campus. No matter which model—or combination of models—is selected, housing will be a significant part of the mix, and another advisory group is devoting itself to this vital issue. The desired outcome is not a purely institutional zone, but rather a vital new community

with appropriate amenities to serve both its Harvard constituents and local residents. To develop this vision further, Harvard and its architecture and planning consultant have embarked on a productive planning process with the Allston community.

Part of the process of creating a community is knitting together the pieces into a greater whole. In fiscal 2002, Harvard made visible progress in this direction when WGBH agreed to relocate its studios and offices from Allston to nearby Brighton. This move will free parcels of land, currently occupied by WGBH, adjoining and across from the Business School on Western Avenue, at the heart of the University's proposed new district. Harvard is also planning for the redevelopment of the northern part of the main Cambridge campus. This redevelopment effort includes plans by the Faculty of Arts and Sciences to provide much-needed new laboratory space while extending the sense of campus by creating new quadrangles and green space. The planning process involves working with the surrounding neighborhood as well as city and state officials, moving existing surface parking to an underground facility, and addressing infrastructure and environmental issues.

THE PHYSICAL PLANT

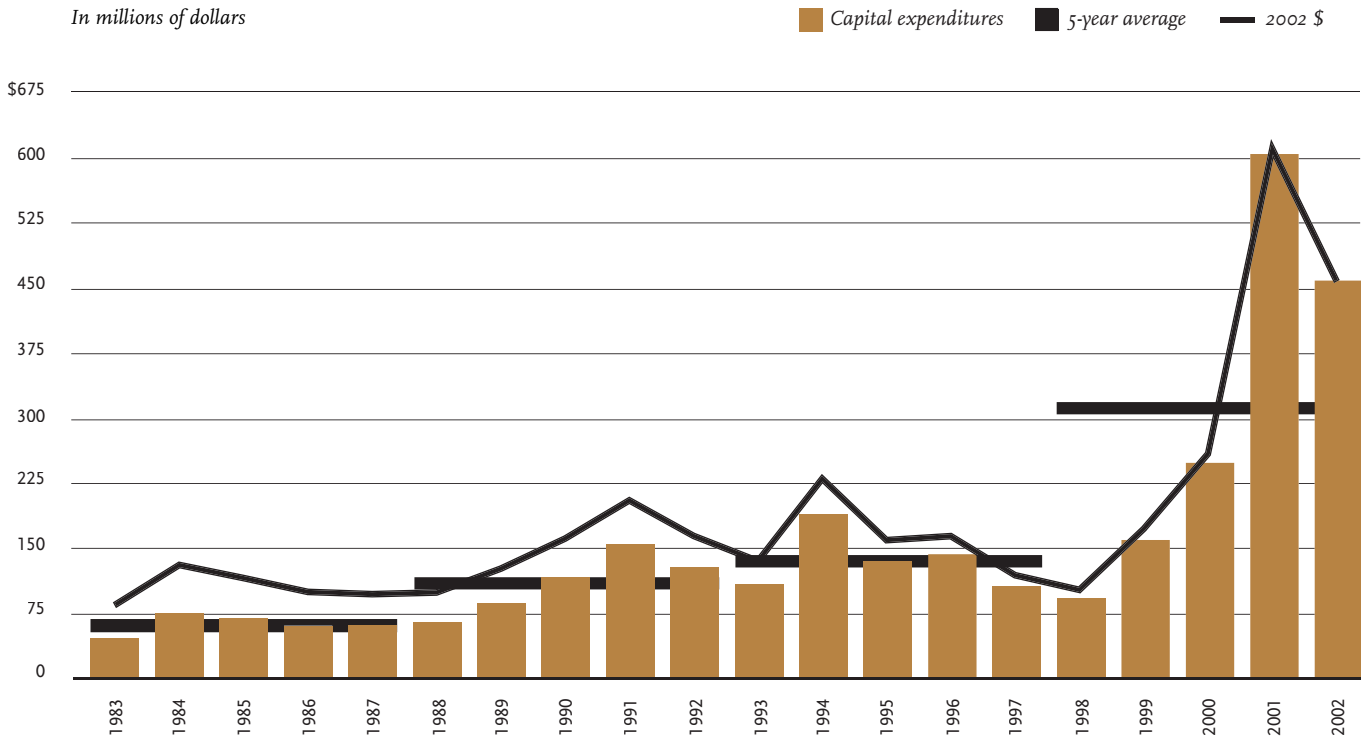
Harvard owns a large, complex physical plant—20.2 million square feet of space at the end of fiscal 2002—that must accommodate diverse management issues and needs, including security, energy efficiency, accessibility, and 24-hour use. Student housing occupies 6.3 million square feet; offices and classrooms, 4.7 million square feet; laboratories, 3.5 million square feet; libraries, 1.5 million square feet; and other facilities including museums and buildings for athletics, health care, administration, and commercial space, 4.2 million square feet.

In fiscal 2002, the University invested \$460.1 million in approximately 400 active capital projects and acquisitions, compared with \$606.4 million during the prior year. For additions placed in service

in fiscal 2002, the Schools spent 66% on laboratories, classrooms, and offices; 21% on libraries, museums, and assembly spaces; 9% on housing; and 4% on athletic and other facilities. Major funding applied to capital projects included \$115.7 million from unrestricted balances, \$31.0 million from gifts, and \$8.5 million from endowment, with the balance funded by debt. For the last two decades, Harvard has employed the strategy of financing capital projects with debt, which has enabled the University to renew and improve its facilities and to pay for those improvements over time. Harvard's outstanding debt at the close of fiscal year 2002 was \$1.8 billion, compared with \$1.6 billion at the close of fiscal 2001.

ANNUAL FACILITY EXPENDITURES

In millions of dollars



NEW CONSTRUCTION AND ACQUISITIONS

New construction and acquisitions accounted for 61% of the University's capital expenditures during fiscal 2002. Significant new facilities were both completed and begun during the year.

At the northern end of the campus, the Bauer Laboratory was completed and dedicated. This cross-disciplinary science building houses the Bauer Center for Genomics Research. A few hundred yards away, construction commenced on the University Information Services building on Hammond Street. This building contains design features, including a stepped-down facade and roof garden on the Hammond Street side, to create a transition between the University and the neighborhood.

At the Business School (HBS), Hawes Hall was completed and dedicated in early spring 2002. This new classroom building provides much-needed additional capacity. Moreover, by integrating innovative technology with HBS's unique amphitheater design, Hawes Hall enhances the dynamic interchange that defines the School's hallmark case teaching method. Part of the original master plan for the campus, it completes an academic quadrangle with Aldrich Hall and Baker Library.

Construction continued on the Medical School's new 525,000-square-foot research building. The facility, which will house researchers from

both basic science departments and affiliated institutions, is designed to increase the level of collaboration that fosters leading-edge work in the biomedical sciences. The development will also include a major conference center.

Harvard is addressing the critical need for graduate-student housing. In Allston, One Western Avenue is taking shape above its nearly completed parking garage. The complex, which will house more than 350 graduate students, features a tower that echoes others along the river and a front entrance on Western Avenue, the major thoroughfare of the new Allston district. The 626-space underground parking facility will serve both tenants and the Business School.

RENOVATION AND RENEWAL

With a physical plant whose buildings span nearly three centuries, Harvard is committed to renovation and renewal as a means both to preserve its architectural assets and to adapt the use of buildings in creative ways to meet evolving needs. Investment in the existing physical plant represented 39% of total capital expenditures in fiscal 2002.

During the fiscal year, the need for more and better graduate-student housing was addressed through renovation as well as new construction. At 29 Garden Street, renovations began that will not only add more units to this 1920s building, but also make it more functional and affordable.

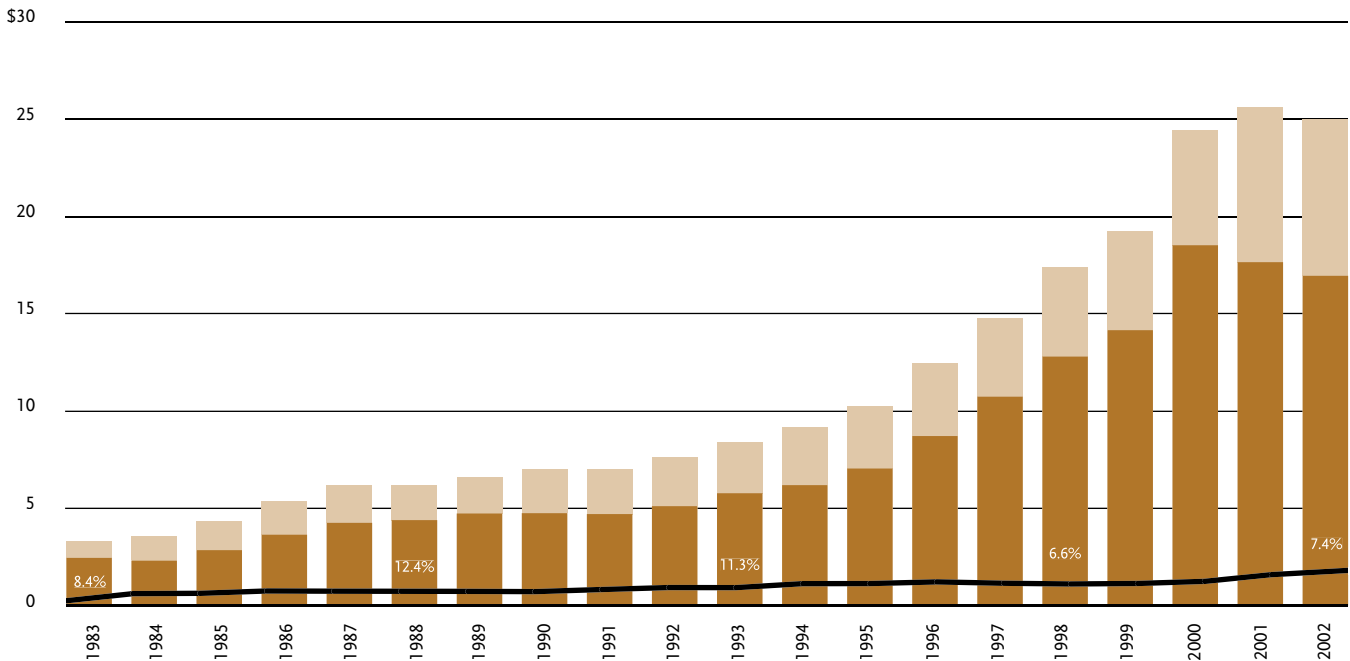
Widener Library continued to be a focal point of renewal activity. The first phase of renovation, which concentrated on the stacks and systems of the library, reached completion. Work on the second phase, which was launched at the end of

fiscal 2001, progressed throughout fiscal 2002. In this phase, public and administrative spaces are being reconfigured for greater functionality, with busy, interactive spaces separated from quiet reading rooms. The first floor, where users enter, will become a hub to connect them with the various services of the library. There will be a new reference and research services room adjacent to the main Loker Reading Room so that patrons will be able to confer with librarians without disturbing readers, as well as a new periodicals reading room on the first floor. Original architectural features and finishes will also be restored during this phase.

COMPARISON OF DEBT TO TOTAL ASSETS

Dollar amounts in billions

Endowment assets Other assets Total debt % Ratio of debt to total assets



Assets are net of pledges, interests in perpetual trusts, and securities pledged to counterparties.

Annual report of the Harvard Management Company

Harvard Management Company (HMC), a wholly owned subsidiary of Harvard University, was founded in 1974 to manage the University’s endowment, pension assets, working capital, and deferred giving accounts. HMC is governed by a Board of Directors that is appointed by the President and Fellows of the University.

HMC currently manages \$21.1 billion, of which \$19.5 billion resides in the General Investment Account (GIA), a pooled fund that consists primarily of endowment assets. The information presented below relates to the GIA.

THE POLICY PORTFOLIO

The cornerstone for the management of the GIA is the Policy Portfolio, the long-term asset mix that is most likely to meet the University’s long-term return goals with the appropriate level of risk. It serves as the benchmark against which the performance of the actual portfolio is measured. The components of the Policy Portfolio at the end of 2002 are shown below:

Domestic equities	15%
Foreign equities	10
Emerging markets	5
Private equities	13
Absolute return funds	12
High-yield securities	5
Commodities	13
Real estate	10
Domestic bonds	11
Foreign bonds	5
Inflation-indexed bonds	6
Cash	(5)
TOTAL	100%

Several points about the Policy Portfolio are worth noting. First, it is a well-diversified portfolio with an attractive expected return-to-risk ratio. It includes a higher allocation to foreign securities and commodity-based assets and a lower allocation to domestic fixed-income assets than the typical institutional fund. Second, while performance will be measured against the Policy Portfolio, the actual asset mix in the portfolio may differ from the Policy Portfolio at any point in time. For instance, if domestic equities are perceived to be overvalued, the actual portfolio may hold only 12% in domestic equities compared with the 15% weight in the Policy Portfolio. If these tactical asset allocation decisions are correct, on balance, the actual portfolio will tend to outperform the Policy Portfolio. Also, if HMC succeeds in outperforming the benchmarks for the individual asset classes (for example, the Lehman 5+ year Treasury Index for the domestic bond sector), the actual portfolio will outperform the Policy Portfolio. The Policy Portfolio is regularly reviewed and modifications are made periodically in light of experience and changing circumstances.

FISCAL 2002 INVESTMENT RESULTS

Total return on the GIA for the year ended June 30, 2002 was a negative 0.5%. This figure is net of all fees and expenses and compares with a negative 4.5% return on the Policy Portfolio.

The table below shows total return on the GIA for each of the past ten years. The Policy Portfolio is shown for comparison as is the Trust Universe Comparison Service (TUCS) Median, a

universe of more than 100 funds with assets of over \$1 billion. As the numbers indicate, endowment returns on average have exceeded returns on the Policy Portfolio and the TUCS Median by a substantial margin.

TOTAL RETURN

Fiscal year	Harvard GIA*	Policy portfolio	TUCS median
1993	16.7%	12.7%	14.1%
1994	9.8	6.8	3.6
1995	16.8	17.2	16.1
1996	26.0	22.3	17.6
1997	25.8	20.0	20.3
5-YEAR ANNUAL RATE	18.9	15.7	14.2
1998	20.5	17.1	17.9
1999	12.2	18.9	11.2
2000	32.2	18.6	10.4
2001	(2.7)	(9.8)	(5.7)
2002	(0.5)	(4.5)	(5.9)
5-YEAR ANNUAL RATE	11.6	7.3	5.4
10-YEAR ANNUAL RATE	15.2%	11.4%	9.9%

*Net of all fees and expenses

RESULTS BY ASSET CLASS

The following section discusses the investment management philosophy for each of the asset classes of the General Investment Account as well as fiscal 2002 investment results.

DOMESTIC EQUITIES In fiscal 2002 the domestic equity program returned (12.2)% compared with (15.3)% for the domestic equity benchmark. The largest portion of the domestic equity portfolio is managed by an external management group that spun out from HMC in July 2001. This group slightly outperformed their benchmark in fiscal 2002. Four other external managers, retained to manage small capitalization equities, outperformed by a wide margin. An internal strategy focusing on arbitrage strategies—merger arbitrage, convertible arbitrage, and pairs trading—underperformed its benchmark by 3%.

FOREIGN EQUITIES The foreign equity program returned (6.5)% in fiscal 2002, compared to (8.7)% for the foreign equity benchmark. The internally managed foreign equity portfolio, which focuses on arbitrage opportunities, outperformed the benchmark by 2.8%. The two external managers retained to manage foreign equities also outperformed the benchmark in fiscal 2002.

GENERAL INVESTMENT ACCOUNT ASSET ALLOCATION

The table below shows the breakdown by asset category of the General Investment Account as of June 30, 2002 and June 30, 2001.

	June 30, 2002		June 30, 2001	
	\$ Millions	Percent	\$ Millions	Percent
Domestic equities	\$ 3,384	17.3%	\$ 4,298	21.4%
Foreign equities	2,707	13.9	3,202	16.0
Emerging markets	1,398	7.2	1,794	8.9
Private equities	1,758	9.0	2,122	10.6
Total	9,247	47.4	11,416	56.9
Absolute return funds	2,029	10.4	1,347	6.7
High-yield securities	1,222	6.3	643	3.2
Commodities	1,841	9.4	1,618	8.1
Real estate	1,025	5.2	1,284	6.4
Total	6,117	31.3	4,892	24.4
Domestic bonds	2,796	14.3	2,370	11.8
Foreign bonds	1,374	7.0	905	4.5
Inflation-indexed bonds	1,755	9.0	1,575	7.8
Cash	(1,764)	(9.0)	(1,084)	(5.4)
Total	4,161	21.3	3,766	18.7
TOTAL	\$ 19,525	100.0%	\$ 20,074	100.0%

EMERGING MARKETS Three strategies are used to manage equities in the emerging markets program—countries in which the capital markets are smaller and less developed than those in the foreign equity sector. The first strategy is an internally managed fund that has concentrated on closed-end funds selling at a discount to net asset values. This fund outperformed the benchmark in fiscal 2002 by 7%. The second strategy employs an external manager and outperformed by 3%. Finally, a small portion of emerging market equities is in private equity funds. This strategy outperformed in fiscal 2002. Overall, the emerging market equity program returned 7.5% compared to 1.9% for the benchmark.

PRIVATE EQUITIES Private equity returns in fiscal 2002 were (19.7)%, roughly equal to the (20.2)% for the benchmark, a broad index of private equity funds. At the end of fiscal 2002, the private equity portfolio consisted of 170 funds managed by 60 different external management teams. Private equity returns were disappointing in fiscal years 2001 and 2002, but extremely rewarding in the three prior fiscal years.

ABSOLUTE RETURN FUNDS Four external managers are employed to provide positive returns without regard to a specific security index. These managers typically focus on merger arbitrage, convertible arbitrage, pairs trading, and balance sheet arbitrage with a sprinkling of absolute value trades. Ideally, these managers will be sufficiently hedged to generate positive returns in either up or down markets. In fiscal 2002, this program returned 10.2%, exceeding the benchmark by a substantial margin.

HIGH-YIELD SECURITIES The domestic portion of the high-yield portfolio is managed externally by two firms that emphasize flexibility and situations where debt securities appear to be incorrectly valued. One manager outperformed in fiscal 2002, while the other fell short. The emerging market debt portion of the high-yield program is managed internally and had a strong year, outperforming the benchmark by 5.6%. Overall, the high-yield portfolio matched the performance of its benchmark in fiscal 2002.

COMMODITIES The commodity portfolio has two components. The first strategy attempts to outperform an index of publicly traded commodities by discovering and exploiting mispricings among similar securities. This strategy outperformed its benchmark by 3.1% in fiscal 2002. The second component of the commodities program is a portfolio of timber properties. This strategy outperformed its benchmark by nearly 10% in fiscal 2002.

REAL ESTATE The real estate portfolio returned (1.0)% in 2002 compared with 4.8% for the benchmark. This underperformance was due to aggressive fair market value markdowns on our portfolio in the fourth quarter of 2002. The real estate benchmark may have been slow to reflect the current environment, in which case our portfolio will catch up with the benchmark over the next year or two.

DOMESTIC BONDS The domestic bond portfolio returned 14.8% in fiscal 2002 compared with 9.2% for the benchmark. The entire domestic bond portfolio is managed internally with a focus on arbitrage situations—the opportunity to buy relatively cheap securities and simultaneously sell overvalued securities with similar characteristics. Since the overall maturity structure and duration of the portfolio is kept close to the benchmark index, interest rate movements typically have little influence on relative performance.

FOREIGN BONDS The foreign bond portfolio returned 32.4% in fiscal 2002 compared with the return on the J.P. Morgan non-U.S. Bond Index of 15.6%. As with domestic bonds, the emphasis is on arbitrage. Duration and country allocation do not vary substantially from the benchmark.

INFLATION-INDEXED BONDS Inflation-indexed bonds were added to the Policy Portfolio in fiscal 2000. These securities, which the U.S. Treasury first issued in January 1997, provide a guaranteed rate of return over the CPI inflation rate. The return on the inflation-indexed bond portfolio was 9.2% in fiscal 2002, closely in line with the benchmark return.

RISK MANAGEMENT

The active management of a diverse portfolio involves inherent risks essential to meeting the long-term return objectives of the endowment. The primary risk factors include market risk, credit risk, liquidity risk and operational risk. The management of these risks is the responsibility of the Board of Directors and senior management, who determine the objectives and policies that govern the management of the endowment. HMC has implemented a series of risk management processes to identify and quantify the risks to which we are exposed, establish the proper mitigating controls, and monitor compliance with risk mitigation strategies. Risk management techniques are structured around fundamental principals including clearly defined policies and procedures; segregation of duties with clear reporting

lines; strong management information systems, measurement and analytical tools; disciplined relationship management; and independent review.

1) Market risk is defined as the sensitivity of income and capital to variations in interest rates, foreign exchange rates, equity prices, commodity prices, and other market-driven rates and prices. Market risk also considers the correlation risk among investments and the liquidity of the underlying positions. Market risk is measured as the potential gain or loss resulting from price change at a given probability over a specific time period; this is also described as value at risk. Value at risk is monitored and reviewed frequently by the Board of Directors and senior management to ensure that exposures are

consistent with approved limits and guidelines. Stress tests are also conducted to determine how potential changes in market conditions could impact the market risk of the portfolio.

2) Credit risk is defined as the risk of loss arising from a counterparty's failure or inability to meet payment or performance terms of a contract. HMC manages credit risk by establishing strict credit policies, setting concentration limits and approval procedures, and monitoring exposure continuously. HMC enters into arrangements with counterparties believed to be creditworthy and requires collateral to the maximum extent possible. Limits are established for each counterparty based on the creditworthiness of the firm.

3) Liquidity risk considers the risk of loss arising from the inability to meet funding commitments. The objective of liquidity risk management is to ensure the ability to meet the endowment's financial obligations. Effective management of liquidity risk requires the ability to project and understand all cash flows and potential future commitments. It also involves the identification and prioritization of sources of liquidity. Cash is managed actively by a centralized staff responsible for understanding our funding requirements and evaluating sources of liquidity. Liquidity measures are employed to ensure that we are maintaining adequate liquidity and that we are prepared for periods of stress.

4) Operational risk is the risk of loss as the result of inadequate or failed internal processes or systems, errors by employees, or external events. The management of these risks is primarily the responsibility of the business line managers in each functional area. HMC manages operational risk by identifying areas of risk, monitoring compliance, promoting best practices, and implementing internal controls and robust systems. The results of these activities are reviewed frequently by senior management, and an extensive review of these controls is performed during our external audit process.

