May 10, 2002

Investing on the Edge

By JOHN L. PULLEY, Chronicle of Higher Education

Cambridge, Mass. -- On a raw, gray morning in early March, at an hour considered inhospitable by most undergraduates, students in torn jeans and hooded sweatshirts gather at the gates of Harvard University's Loeb House.

The group, members of HarvardWatch, is here to get in the face of the Harvard Corporation, the university's powerful governing board -- "a hotbed of crony capitalism," screams a sophomore, Daniel DiMaggio, warming up the crowd with a bullhorn -- which is meeting this morning.

The students rail about Harvard's close ties to the Enron Corporation and question the propriety of the university's making millions from investments in a hedge fund that profited when the energy company collapsed. They cheer the recent resignation from the Harvard Corporation of Herbert S. Winokur Jr., an Enron director and codefendant in a sweeping class-action lawsuit, who cited the furor over his connection to the troubled company in deciding to step down. They jeer the appointment to the board of another figure named in that legal action, Robert E. Rubin, the former treasury secretary.

Barred from the Loeb House grounds by an iron fence and a thick-necked university policeman, the students march on a public sidewalk, demanding "the almighty truth rather than the almighty dollar." But for all the hoopla, those who count at Harvard see it as little more than the protest du jour. Harvard's money managers did what they were paid to do, the rich got richer, and can't we just move on?

At the same time, 3,000 miles away, another Enron story unfolds, with far graver overtones.

The University of California system lost $145-million on its Enron investments. Now the university has called a news conference at its San Francisco campus and they announce that they will be the lead plaintiff in a 500-page lawsuit charging 38 of Enron's directors and top executives with defrauding investors of billions of dollars. Also charged in the suit are 28 partners, accountants, and affiliated entities of Arthur Andersen, nine banks, and two law firms. The university has taken the lead in the lawsuit, says James E. Holst, its general counsel, "because of our concern for the integrity of the capital markets."

He is joined at the news conference by the class action's lead lawyer, William S. Lerach, of Milberg Weiss Bershad Hynes & Lerach, which bills itself as the country's largest class-action law firm. Mr. Lerach, the Johnnie Cochran of securities litigation, is a flamboyant and feared lawyer who has recouped billions of dollars for aggrieved shareholders. "Enron," he says, "was a hall of mirrors inside a house of cards."

The trial is scheduled to begin in the fall of 2003, and it may not be resolved for years.

The collapse of Enron has affected scores of colleges and universities that owned the company's stock, either outright or through diversified funds. Yet perhaps nowhere in higher education has the fallout from the Enron debacle diverged more sharply than at Harvard and the University of California.

California -- the vast, West Coast public university system, whose newer campuses have very small endowments -- lost buckets of money on its Enron holdings, more than any other college or university, and has broken with tradition and taken the fight to those it blames for the loss.

But Harvard -- the private, wealthy, stand-alone East Coast university that is older than the country itself -- profited from its Enron investments, perhaps more so than any college endowment. In a year when the investments of most endowments, including Harvard's, lost money, its allocation to absolute-return strategies (an investment style favored by hedge-fund managers) posted a spectacular return of 27 percent.

In the end, there is little doubt that the divergent outcomes stem from the two universities' respective investment strategies.

"There is a difference in the way those two institutions have chosen to manage their largest asset," says Mark W. Yusko, chief investment officer for the University of North Carolina at Chapel Hill. "One [Harvard] has taken a very active approach, hired the best and brightest from Wall Street, and paid salaries that, while they don't meet Wall Street, get close."

California, by contrast, is "a larger institution that is more conservatively focused on cost reduction," says Mr. Yusko. "A lot of times, you get what you pay for. You don't want to minimize costs at all costs."

Fundamental Differences

In late May 2000, the University of California's endowment managers were bullish on the stock of Enron -- then the country's seventh-largest company and just the kind of fast-growing global enterprise they favored. "The interest in Enron arose out of our internal analysis of the energy sector and attractive companies within it," says Trey Davis, a university spokesman.

Determined to make all investment decisions in-house, with a staff of two dozen experts, the university treasurer's office lacked the manpower to consider stocks issued by small and medium-size companies. Other labor-intensive investments, like hedge funds, were out of the question. Besides, the university's investment guidelines prohibit "shorting" stocks, a favorite strategy of hedge-fund managers. Short sellers make bets that the stock price of certain companies will fall. If they guess right, they profit.

The ban on short selling exemplifies a fundamental difference between Harvard and California, their systems of governance, and their overall investment philosophies.

The endowment at Harvard is managed through an independent subsidiary, the Harvard Management Company, whose board is appointed by the Harvard Corporation. Members of both boards are selected in secret. So, as with most private-university boards, the management company's leaders form a small, homogeneous, business-savvy group that affords its endowment managers the elbow room they need to maximize returns. The university's constituents have no voice in investments, but as long as the endowment continues to grow at a brisk pace, most stakeholders seem happy to remain mute. At the close of the 2001 fiscal year, the endowment was valued at $18.3-billion.

Conservative Investing

The University of California manages its endowment in its treasurer's office. Under the university's broadly democratic system of oversight, the treasurer reports to the Board of Regents, consisting of 18 members appointed by the governor, one student, and seven ex officio members, including representatives of alumni and the faculty. Disparate constituencies have a voice, but management by committee tends to result in conservative policies that are broadly palatable. Hence, no shorting stocks.

"Our guidelines are very rigid," says Melvin L. Stanton, California's assistant treasurer.

Enron must have looked like a safe bet to California. Its endowment loaded up on 154,700 shares of stock in the company through the end of June 2000, at prices ranging from $65 to $70 per share. During the same period, the system's retirement plan bought almost 1.24 million shares at a cost of $84.8-million. (The same managers who invest the university's $5.1-billion endowment also oversee $45-billion in pension and other retirement funds, as well as other money, a total of $55-billion.) By the end of June, the university had spent more than $106-million to acquire 1,546,300 shares of Enron stock.

Initially, it looked like a smart move. During the 18 months leading up to California's first investment in Enron, the company's share price had more than doubled, from $30 at the start of 1999. And it kept rising. Later in the summer of 2000, the stock rose briefly to $90 per share, its all-time high, creating a paper profit of more than $28-million for the university.

By September, the price of Enron's shares had begun to slide, and by late November, the stock was trading in the low $60's. Sensing a buying opportunity, the university's money managers acquired more than 200,000 additional shares. And over the next year, State Street Global Advisors, which manages a passive index fund for the university, added 478,000 shares to the university's total Enron holdings. When the last share had been bought, California held 2.2 million shares of Enron stock purchased for $155-million.

Betting Enron to Lose

From the 51st floor of an office building on Clarendon Street in Boston, Enron looked considerably less attractive. By early 2001, analysts at Highfields Capital Management, a hedge fund located a few blocks west of Boston Common, had concluded that the energy company's stock might be overvalued. That view prevailed, even as California and other institutional investors were larding their portfolios with Enron stock.

Highfields was founded in 1998 by Jonathon S. Jacobson, a star money manager who had left the security and high pay of the Harvard Management Company -- he earned a $10-million bonus in his final year there -- to open his own shop. Jack R. Meyer, president and chief executive officer of the Harvard Management Company, gave the fledgling hedge fund seed money, entrusting his protege to manage $500-million of the university's endowment. That original stake has since grown to at least $1-billion, and some sources put its value at twice that.

In the 2000 fiscal year, Harvard paid Highfields management fees totaling more than $29.2-million, making the hedge fund the university's most richly compensated independent contractor, according to Harvard's tax filings.

Put Options

In a now infamous conference call for investors in April 2000, Richard Grubman, a managing director of Highfields, grilled Enron's chief operating officer at the time, Jeffrey K. Skilling, about the value of assets held by Enron's partnerships. (Two years later, the University of California's lawyers would cite such partnerships as the primary vehicles used by Enron to hide debt, inflate earnings, and defraud investors.)

Flustered by Mr. Grubman's pointed questions, Mr. Skilling referred to the analyst with a vulgar epithet. Six months la-ter, during another conference call, Enron's chairman, Kenneth L. Lay, refused to answer Mr. Grubman's questions and accused him of driving down the company's stock price.

For most of the second quarter of 2001, Enron stock traded below $60 per share. Highfields, betting that the stock's price would continue to decline, bought "put" options on 1.2 million shares of the stock, according to filings with the Securities and Exchange Commission.

Owners of puts have the option of selling shares of a stock at a predetermined price for a specified period of time. If the price of the stock falls, the holder of the options buys cheap shares on the open market and sells them at the higher price, profiting on the difference.

By the end of the third quarter of 2001, Enron's stock was trading in the mid-$30's. Meanwhile, Highfields continued to purchase puts, acquiring options on more than 62,000 additional shares from July through September, according to filings with the SEC. Three months later, Enron-related investments by Harvard and California would bear fruit, sweet and sour.

As Enron's stock price fell, California doggedly held its investments, almost to the bitter end. The university finally unloaded most of its shares in mid-November, just before Enron filed for bankruptcy, at an average price of $ 5.33 per share.

State Street Global Advisors divested the remainder of California's Enron stake, almost 467,000 shares it owned on behalf of the university, on December 4, two days after the filing. The stock sold for 36.5 cents per share.

Huge Losses

In the span of a little more than 18 months, California's investment in Enron had lost $144.9-million.

"Maybe the University of California is being as aggressive as they are because they should have been watching the store more closely," says Saul S. Cohen, a securities-litigation specialist in the New York law firm of Proskauer Rose.

The extent to which Harvard's endowment profited from Enron's collapse is not known, but using a set of what it calls "conservative" assumptions, HarvardWatch estimates that Highfields turned a $50-million profit. But how, when everyone else was losing millions, did Harvard manage to make a tidy profit? The same way, the group claims, Enron's executives were able to cash out stock options and pocket more than $1-billion in ill-gotten gains: Harvard cheated.

Seemingly building its own house of cards, HarvardWatch speculates that the university's various connections to Enron and Highfields could have allowed Harvard or its agents to engage in insider trading -- claims that are roundly denied.

"Yes, we did make money," says the Harvard Management Company's Mr. Meyer, who typically does not discuss the composition of the endowment's portfolio, much less the performance of individual trades. But as for the insider-trading allegations, "there's not a shred of evidence," he says. "It's baseless and irresponsible, and it didn't happen."

HarvardWatch concedes that its suspicions are based on circumstantial evidence, and that it has no smoking gun.

Profiting From Experience

Harvard and California have taken away very different lessons from the Enron collapse. California's public role in the class action, which seeks to recoup overall investment losses estimated by Mr. Lerach, the lead litigator, at $ 25-billion to $30-billion, "is a rare and extraordinary legal step for the university," says Mr. Holst, the system's lawyer. Indeed, higher-education institutions rarely are in the vanguard of such high-profile legal actions. In this case, though, the university moved to the fore, persuading a federal judge to name it the lead plaintiff in the class-action suit.

There's a reason for universities' reluctance, says Larry Goldstein, a senior fellow at the National Association of College and University Business Officers. "There are so many stakeholders that you never know who you might alienate."

That reluctance to step up, though, may be fading, says Jay Morley, NACUBO's president.

"It's too early to tell, but I would suspect that if there continues to be egregious losses that come from questionable management practices, that institutions with large holdings would look to take action and seek recovery" of losses, he says.

Rigid Guidelines

California is also reviewing its rigid guidelines, at the behest of the system's regents, with an eye toward permitting a wider range of investments.

The regents could vote on the changes as early as this month. But more important, perhaps, the university is learning the value of watchfulness and flexibility. "As problems crop up in various companies that we own [stock in], we are more quickly involved in jumping in to evaluate," says Mr. Stanton, California's assistant treasurer. "We are much more responsive."

Back in Cambridge, the stakes are just as high.

"Harvard doesn't want to be seen as profiting from other people's misfortunes," says Mr. Yusko, the North Carolina money manager. "There are a lot of innocent people who don't have pension funds now."

Will Harvard be tarred by the same brush that has painted Enron's executives and their codefendants as pirates and profiteers? The lesson here is an old one: In the court of public opinion, guilt by association is admissible.