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News

HMC Analyst Questions Dismissal

Analyst says she was fired for criticizing controversial investment practices

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After a year-long stint at a European investment bank and another at Enron, Iris M. Mack signed on to be a quantitative analyst for Harvard Management Company in early 2002, hoping, she says, to find job security and distance from the risky trading and accounting practices that forced her last employer into bankruptcy in the company charged with managing Harvard's endowment.

But only a few months later, Mack says she was fired after she raised concerns to University officials about managers' qualifications and possibly irresponsible usage of financial instruments that could have contributed to the recent and sudden decline in Harvard's endowment.

In an e-mail sent May 30, 2002 to Marne Levine, chief of staff for then-Harvard President Lawrence H. Summers, Mack detailed her concerns regarding what she deemed HMC's "frightening" usage of derivatives and statistical modeling techniques, as well as the Company's lack of a timely and portfolio-wide risk management system, high employee turnover rate, and low level of productivity in the workplace, specifically among managers.

According to documents and e-mail records, all provided by Mack, Levine had initially assured Mack that their correspondence would remain confidential. But on July 1, HMC chief Jack R. Meyer called Mack into a meeting, in which she was presented with copies of her e-mails, according to a letter sent to Levine and Summers by Mack's attorney.

The next day, Meyer dismissed Mack, pointing to "these baseless allegations against HMC [that you sent] to individuals outside of HMC," the letter says.

Meyer declined to comment for this story, and Levine could not be reached.

Harvard spokesman John D. Longbrake says that while the University does not comment on the specifics of personnel cases, "all allegations brought to the attention of the Management Company and its board are taken seriously and investigated thoroughly in order to ensure the integrity of HMC processes." He further points to HMC's average annual investment return of 13.8 percent over the 10 years up through 2008 as evidence of the Company's "strong portfolio management, personnel and risk management systems."

But Mack, a derivatives researcher for Enron before coming to HMC, says she was "shocked" by the mishandling and ignorance of derivatives at the HMC international equities division where she worked, led by Jeffrey B. Larson. At the time, Mack says, Larson's group had only recently begun exploring more sophisticated financial instruments such as credit default swaps and capital structure arbitrage.

And while she says her concerns were dismissed at the time, recent market turbulence has called into question the use of some of these financial instruments, lending more credibility to Mack's criticisms.

After years of soaring returns, the University's endowment plunged at least 22 percent in the four months starting July 1, and Harvard officials are projecting a decline of 30 percent for the full year.

"The group I was working for had no background whatsoever to be working on those," Mack says, adding that, to her knowledge, several of her colleagues were not licensed securities traders. "Sometimes the ways they handled even basic Black-Scholes models [widely used to price stock options] were puzzling."

THE BOTTOM FALLS OUT

A 13-year veteran of HMC, Larson delivered 11.6 percent average annual gains in his section of the Company's portfolio for the five years prior to his departure, blowing past the 4.1 percent benchmark for his asset class, according to the Boston Globe.

Larson left HMC in 2004 with a $500 million initial investment from Harvard to start his own hedge fund, Sowood Capital Management. But Sowood collapsed in 2007 due to heavily leveraged investments in corporate debt—making national headlines as one of the first high-profile hedge fund implosions of the subprime mortgage crisis—costing Harvard $350 million.

Mack stresses that she has nothing personal against Larson and that he was a very adept stock trader, but that he "had no background to be trading derivatives."

Larson could not be reached by phone for comment at his Wellesley home over the past week.

According to Harvard's annual financial statement issued in October, the University continues to use a variety of financial instruments with undisclosed risk—including options, forwards, credit default swaps, and exchange agreements—to gain exposure to various asset classes without having to actually invest in those assets.

And the instruments performed well. The net ending fair value [or net gains/losses] of these equity, fixed-income, commodity, currency, and credit instruments totaled over $600 million as of June 30, representing a gain from the $100 million in net ending fair value from the previous year.

But that was before the bottom fell out from nearly every asset class. While some of the instruments, such as credit default swaps, may have hedged against the downturn, other derivative holdings have cost the University dearly. Harvard's investments in interest-rate swaps, one class of derivative that may be used by both HMC and the University budget office to hedge against interests rate changes on variable-rate debt, would have cost $571 million to terminate as of Oct. 2008, according to a credit rating report from financial rating company Standard and Poor's.

For his part, Larson appears to have adopted a more conservative investing approach. Last May, he was widely reported to have plans for a new firm to manage what marketing documents obtained by Reuters billed as a less risky, "limited leverage, value driven portfolio."

'VINDICATED'

Ultimately, Mack says she reached an out-of-court settlement with Harvard over her firing because her lawyers felt that the University did not want to attract media attention from the dismissal, and that the case could be dragged out over a long period, making it difficult to litigate.

Jonathan J. Margolis, an employment lawyer with Boston-based Rodgers, Powers & Schwartz LLP who provided counsel for Mack, wrote in a letter to Summers and Levine dated July 24, 2002 and provided by Mack that "Harvard University wrongly and unlawfully interfered with Ms. Mack's contractual and advantageous relations with Harvard Management Company." He further suggested that they contact him as soon as possible to explore informal resolutions to the incident if they wished to avoid a lawsuit.

Ultimately it was Philip Hilder—the lawyer who had represented the Enron whistleblower Sherron Watkins in Congressional hearings following the company's collapse—who secured the settlement from Harvard.

Hilder says that he remembered Mack's case and that while he could not discuss the specifics of the settlement, it is notable that "she had the foresight to see derivatives as a problem as early as she did."

Mack says that while the initial severance package offered to her by Harvard was scant and restrictive—Margolis' letter to Summers and Levine says it consisted of little more than a bonus she had received before the incident—she reached a more acceptable settlement seven months later. Mack says that her settlement with Harvard forbids her to discuss the specific terms of the agreement or to distribute "Harvard's property," which includes the dismissal letter from Meyer.

Now, with the economy in an unprecedented slump in part due to the widespread and unregulated use of derivative contracts, Mack says she feels "vindicated" but also sad.

"I'm not trying to pretend I'm omniscient or anything, but a lot of people who were quantitative traders, in the back of our minds, we knew a lot of these models were just that: guestimates," Mack says. "I have mixed feelings, on the one hand, I wasn't crazy, I knew what I was talking about. But maybe if more and more people had spoken up, the economy wouldn't be the way it is now."

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