

Minnesota 3M PFAS Settlement Investment Plan

Background

The 3M Settlement resulted in a \$850 million grant with \$700 million allocated to Priority 1, the amount available after payment of legal fees, expense repayments, and deducting the \$20 million set aside for Priority 2. Priority 1 funds will be spent on constructing and operating and maintaining drinking water infrastructure projects; providing home treatment systems to private well owners; contingency for additional treatment or alternative water sources; protecting drinking water at the source; and administrative support.

The Minnesota Pollution Control Agency (MPCA) and Minnesota Department of Natural Resources (DNR) are Co-Trustees of the Water Quality and Sustainability Account (Account).¹ The Account was established under Minnesota Statute 115B.52 and allows the Minnesota State Board of Investment to invest the assets, which are currently invested in Invested Treasurer's Cash ("ITC") earning approximately 1% annual interest as of March 31, 2022.

Co-Trustees asked the State Board of Investment (SBI) to consider other potential investment options that would be most appropriate given the spending needs. SBI considered different investment strategies for sub-accounts with a goal of ensuring sufficient funds to implement drinking water infrastructure projects, as outlined in the Conceptual Plan, while covering costs to reduce long-term cost burdens. The Co-Trustees worked with SBI staff when reviewing the investment options available, the risk tolerance and return objectives for the Account, in addition to evaluating various investment scenario forecasts based on asset-liability models and capital market assumptions provided by the SBI's consultant.²

Proposed Sub-Account Structure and Asset Allocation

Investment Objectives: The Account is available to finance various drinking water and natural resource projects. The projects in the Conceptual Drinking Water Supply Plan have been categorized into four different budgeting areas: Capital Spending, Operation and Maintenance, Contingency, and State Administrative Expenses.³ To manage the assets according to the spending needs of each budgeting category, four sub-accounts will be created. Each sub-account will use investment options and have an asset allocation that addresses the investment time horizon, real purchasing power requirements, risk tolerance (ensure safety of principal), and return objectives (meet long-term capital budget items).

Investment options available to the Co-Trustees include:

- 1) Invested Treasurer's Cash (ITC): A portfolio of high-quality, liquid, short-term investments managed by the SBI. The investment objectives of the ITC are to preserve capital, provide liquidity (meet cash needs without forced sale of security at a loss), and provide a competitive rate of return.

¹ Trustees, MPCA and DNR, are responsible for setting funding amounts of the sub-accounts, the asset allocation decisions, and other investment decisions.

² Assumed expected long-term (10-year) returns/standard deviations are 5.8%/17.0% for equities, 1.9%/4.0% for bonds, and 1.5%/1.0% for cash, respectively.

³ The \$20 million set aside for Priority 2 will remain in the Account, for the time being, invested in ITC.

- 2) Externally-managed Non-Retirement pooled investment vehicles of equity (e.g., stocks), fixed income (e.g., government or corporate bonds), and cash. These are represented by the following:
 - a. Non-Retirement Equity Fund: A passively-managed U.S. equities fund managed by Mellon Corporation which invests in 500 large-cap stocks and is expected to track the S&P 500 Index. The fund's goal is to provide long-term growth and should average higher returns than bonds or money market funds in the long term, but it has the largest risk of capital loss in the short-term.
 - b. Non-Retirement Bond Fund: An actively managed fund of U.S. bonds managed by Prudential Global Advisors which invests in high-quality government and corporate bonds and mortgage securities that have intermediate to long-term maturities. Returns will generally move in the opposite direction of interest rate changes. The fund is moderately conservative, is expected to provide more capital protection than equities but a higher rate of return than money market securities.
 - c. Non-Retirement Money Market Fund: An actively managed money market fund managed by State Street Global Advisors which invests in high-quality, short-term instruments. The fund is expected to provide liquidity and safety of capital while earning money market rates of return. Returns will generally follow the rise and fall of short-term interest rates. Returns from the fund will vary much less than investments that include stocks and bonds and as such are expected to earn less over time.
- 3) Laddered Treasury bonds: An account separately managed by the SBI of laddered Treasury bonds (e.g., bonds issued by the U.S. Treasury that mature on different dates) and some residual cash versus a cash account. An investment in laddered bonds will enhance returns and preserve capital by locking in current expectations of future interest rates to minimize both mark-to-market and reinvestment risk.

Both ITC and the Non-Retirement Money Market Fund are cash accounts. The SBI encourages usage of ITC as a cash preservation option when available. In a multi-asset allocation structure (Option 2), ITC is unavailable as an investment option, and the Non-Retirement Money Market Fund is made available in its place.

Co-Trustees, with support from SBI and input from the working groups, have considered these options for the Account's sub-accounts. Co-Trustees recommend the following asset allocation:

1) Sub-Account: Capital Spending

- a. **Initial funding amount: \$387 million**, which includes \$300 million for drinking water infrastructure projects, \$70 million for drinking water protection project, and \$17 million to cover anticipated inflation.
- b. **Investment goals:** Invest in a way that covers expenses based on Co-Trustees expected capital spending schedule over 10 years and is adaptable to cover costs sooner or later than anticipated if needed. The strategy should also cover potential inflation at an assumed rate of at least 3% as estimated in the Conceptual Plan.
- c. **Asset allocation:** Funds shall be invested in a separate account managed by the SBI and invested in a portfolio of cash and laddered Treasury bonds whose maturities roughly match that of the expected schedule of capital spending. Cash needs shall be funded through the maturity or sale of bonds. Co-Trustees recommend investing 100% of funds in a separate account of laddered Treasury bonds and cash managed by the SBI.
- d. **Rationale:** Given the short-dated nature of spending needs, tolerance for risk is relatively low. Since proceeds will not be needed immediately, investing in a Treasury ladder will enhance returns while preserving capital by locking in current expectations of future interest rates to minimize both mark-to-market and reinvestment risk.

2) Sub-Account: Operation and Maintenance (O&M)

- a. **Initial funding amount: \$115 million**, which includes \$28 million for O&M on POETs (30 years) and \$87 million for O&M on public water systems (20 years).
- b. **Investment goals:** Manage investment risk to increase annual returns and lower the probability of shortfalls in most market conditions to cover and, if possible, exceed the 20- and 30-year O&M projects estimated in the Conceptual Plan, net of potential inflation.
- c. **Asset Allocation:** Funds shall be invested in Non-Retirement pooled investment vehicles of equities, fixed income, and cash. Co-Trustees recommend investing these funds in 40% Equity, 30% Fixed Income, and 30% Cash.
- d. **Rationale:** This share of equities substantially increases the potential for higher returns (growth) to meet the long-term investment objective, while also investing substantially in assets that can protect capital in different economic scenarios (cash and bonds). In consultation with the SBI, Co-Trustees are comfortable with the risk of shortfall in most market conditions and believe that the allocation represents a favorable tradeoff between returns versus downside risk.

3) Sub-Account: Contingency

- a. **Initial funding amount: \$183 million** to address future uncertainty, including future treatment needs, alternative sources of drinking water (if needed), and cost overruns.
- b. **Investment goals:** Invest in a risk-constrained strategy that allows for funds to grow to meet future uncertain needs while focusing more on capital preservation and liquidity than O&M given the potential for short-term capital spending needs.
- c. **Asset allocation:** Funds shall be invested in Non-Retirement pooled investment vehicles of equities, fixed income, and cash. When new project needs become certain, funds will be sold and transferred to the Capital Spending and Operations & Maintenance Accounts. Co-Trustees recommend investing these funds in 25% Equity, 25% Fixed Income, and 50% Cash.
- d. **Rationale:** The asset allocation mix reflects the potential that approximately 1/3 of Contingency funds would be used for Capital Spending and 2/3 for O&M, as estimated by Abt Associates. Because the expected needs and timing are uncertain, the allocation reflects modest growth while limiting the potential for capital loss.

4) Sub-Account: State Administrative Expenses

- a. **Initial funding amount: \$15 million** to cover annual state administration costs over the next 20 years.
- b. **Investment goals:** Invest in a low-risk strategy that ensures funds are available as needed to fund on-going agency expenses.
- c. **Asset allocation:** Co-Trustees recommend 100% of funds shall continue to be invested in ITC.
- d. **Rationale:** This option provides a competitive rate of return in line with the goal of preserving capital and maximizing liquidity, which are stated investment objectives of ITC.

Next Steps

Once the MPCA and DNR Commissioners approve this proposal, Co-Trustees will finalize the sub-account structure and asset allocation and the SBI will prepare a Statement of Understanding, an Investment Policy for the sub-accounts, and Investment Guidelines for the separate account for review by the Co-Trustees. The SBI Board will approve final asset allocations, which is scheduled for May 25, 2022.