

**FORM ADV PART 2A: FIRM BROCHURE**

**Badgley Phelps Investment Managers**

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Form ADV Part 2, is our “Disclosure Brochure” or “brochure” as required by the Investment Advisers Act of 1940, as amended. This brochure provides information about the qualifications and business practices of Badgley Phelps Investment Managers.

If you have any questions about the contents of this brochure, please contact us at (206) 623-6172 or at [info@badgley.com](mailto:info@badgley.com). The information in this brochure has not been approved or verified by the United States Securities and Exchange Commission or by any state securities authority.

Badgley Phelps Investment Managers (hereinafter “Badgley Phelps”) is a registered investment adviser. Registration as an investment adviser does not imply a certain level of skill or training. Please consider all information we provide you, including this brochure, as factors in your decision to retain us as your investment adviser.

Additional information about Badgley Phelps is available on the SEC’s website at [www.adviserinfo.sec.gov](http://www.adviserinfo.sec.gov).

## **Item 2 – Material Changes**

This section of the brochure discusses specific material changes that are made to the brochure and provides a summary of such changes. The last annual update of our brochure was March 6, 2013. Material changes which have been made to our brochure since our last annual update include the following:

### **Amendment to Items 12 (Brokerage Practices), 14 (Client Referrals and Other Compensation) and 15 (Custody):**

Badgley Phelps has revised existing agreements and entered into new agreements with Charles Schwab & Co., Inc. in which Schwab provides to Badgley Phelps various products and services that benefit its clients directly and indirectly as well as providing direct benefit to the firm. These include a soft dollar research agreement, client business referral program, and client benefit agreements. Goods and services provided include access to technology that provides access to client account data, facilitates trade execution, and provides market research. Other services made available by Schwab are provided to help manage and further develop our firm's business enterprise such as business consulting, publications and conferences on practice management, succession planning, compliance, operations and trading. Schwab has made available and arranged payment for certain conferences, training and research services/products.

Our brochure is available at any time upon request without charge. Please request our brochure by contacting our Chief Compliance Officer at (206) 623-6172 or by emailing us at [info@badgley.com](mailto:info@badgley.com).

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## **Item 4 – Advisory Business**

Badgley Phelps Investment Managers was founded in 1966 in Seattle, Washington. Since inception of the firm, Badgley Phelps has provided investment management services to high net-worth individuals and families, corporations, endowments and foundations. Badgley Phelps provides long-term investment strategies utilizing a structured approach of portfolio management utilizing equity, fixed income and alternative securities. Our approach is built on equity, fixed income and alternative security selection methodology, a disciplined investment management process, and client-focused service.

Badgley Phelps has been 100% employee-owned since inception. Currently, Badgley Phelps has 29 employees, of which 13 are also shareholders of our firm. Majority owners of Badgley Phelps are J. Kevin Callaghan and Steven C. Phelps.

An investment manager at Badgley Phelps works with each client to develop an asset allocation for each portfolio and/or client relationship which is aligned with the client's financial goals. The concept of asset allocation, or spreading investments among a number of asset classes, is in the forefront of our strategies. To determine the appropriate asset allocation, we develop a clear understanding of our clients' overall investment situation, return objectives, risk tolerance, tax circumstances and income needs. In some cases, this is done by preparing a financial plan. Once we have concluded this review with our clients and determined the appropriate asset allocation, our investment process is implemented. Clients that wish to restrict investing in certain securities are able to do so upon notification to their investment manager.

Our investment products include equity only, fixed income only, and balanced portfolio management. Brief descriptions follow:

**Equity management** utilizes fundamental/bottom-up research analysis in our security selection process and focuses on identifying companies with strong and consistent earnings growth. Medium to large capitalization stocks of companies registered on the U.S. stock exchanges with a core growth or relative value bias are selected for the equity portion of our clients' portfolios. We manage core growth and relative value portfolios using model portfolios which typically contain 30 to 40 stocks each. In addition, we seek exposure to small and mid-sized U.S. companies in our clients' portfolios by recommending a model portfolio consisting of mutual funds or Exchange Traded Funds ("ETFs"). We also recommend that our clients seek investment returns from non-U.S. markets, so we generally allocate a portion of a client's portfolio to international stocks by investing in a model portfolio of mutual funds or ETFs.

**Fixed income management** emphasizes high-quality, intermediate-term bonds. In tax-exempt portfolios, we generally purchase U.S. government, governmental agency, and high-quality corporate bonds. For taxable portfolios, we typically invest in high-quality municipal bonds, depending upon the client's state of residence and tax status, and fixed income market conditions. Fixed income portfolios can also be structured to meet both short-term and long-term investment goals.

In addition to equity and fixed income securities, **alternative securities** may be used to further diversify our clients' portfolios. Where appropriate, we may add alternative securities such as commodities to a client's portfolio using a commodity model comprised of ETFs or exchange traded notes ("ETNs"). We may also utilize ETFs and ETNs to enhance the risk-adjusted returns of our clients' diversified investment portfolios by investing in securities that we anticipate will increase in value when the volatility of the stock market rises, may rise as the stock market falls and which have a low correlation with stocks and bonds. The goal of this "multi-strategy" process is to diversify the portfolio, help smooth returns, reduce volatility and decrease asset-class risks. These securities may also focus on a shorter investment time horizon than our typical client portfolios. Generally, we allocate a smaller percent of a client's portfolio to alternative investments. Typically ETFs and ETNs provide investors access to the returns of the relative market benchmarks and provide additional diversification characteristics to portfolios of equity and fixed income assets.

**Balanced management** combines equity, fixed income, and alternative investment management methodologies. For those clients who select balanced management, a target allocation between equity, fixed income, alternative assets and cash is determined at the onset of a client relationship based on the client's particular investment goals and requirements. Once this allocation is established, the portfolio is rebalanced to this target allocation ratio. Typically accounts are rebalanced at least once every three months.

Badgley Phelps manages client assets on a discretionary as well as non-discretionary basis. As of December 31, 2013, the market value of all client assets managed on a discretionary basis was \$1,577,327,000 and \$225,149,000 for non-discretionary assets, for a total of \$1,802,476,000.

## Item 5 – Fees and Compensation

Badgley Phelps' standard advisory fee schedules for new accounts are the following:

<b><u>Advisory Fee Schedule for Separate Accounts:</u></b>	<b><u>Portfolio Value at Market:</u></b>	<b><u>Annual Fee:</u></b>
Balanced	First \$5,000,000	0.90%
	Next \$5,000,000	0.60%
	Amount over \$10,000,000	Negotiable
Equity Only (*)	First \$5,000,000	1.00%
	Next \$5,000,000	0.75%
	Amount over \$10,000,000	Negotiable
<i>(*) Generally comprised of a minimum 80% equities</i>		
Fixed Income Only	First \$20,000,000	0.40%
	Amount over \$20,000,000	Negotiable

Each written client agreement with Badgley Phelps establishes the agreed-upon fee schedule. Fees are computed on the market value of assets less non-supervised assets. Clients are billed once every three months for investment advisory services. In any partial calendar quarter, fees are prorated based on the number of days in which the account is open during the quarter. Client portfolios are valued as of a specific pre-determined date to calculate the fee for that calendar quarter. Badgley Phelps requires a minimum client account of \$1,000,000. This minimum may be waived under certain circumstances. Some clients may be billed at a fixed amount due to special circumstances, including but not limited to the type of investment or financial planning work being conducted by our firm.

Fee schedules and minimum account size may be negotiable. Fees may vary from the current fee schedules listed above due to the particular circumstances of the client, the type of investment or financial services provided, or as otherwise negotiated. Examples of these circumstances can include the account inception date, the existence of other accounts managed by Badgley Phelps, account size, minimum annual fee, and/or as otherwise negotiated. Discounts not generally available to our advisory clients may be offered to family members or associated persons of our firm.

Clients have the ability to pay our invoices directly upon receipt. Additionally, with client authorization, Badgley Phelps will deduct the advisory fee from the client's account by directly

billing the client's custodian. Each fee payment is reported on the client's account statement prepared by and sent from the client's custodian.

Accounts initiated or terminated during a calendar quarter will be charged a prorated fee. A client may terminate our services for any reason. We appreciate written notice to terminate. The client's final invoice is adjusted prorata to the termination date with reimbursement to the client for any amounts due to be refunded. Any earned, unpaid fees will be due and payable at account termination.

Badgley Phelps' advisory fees are exclusive of brokerage commissions, custodial fees, transaction fees and other related costs and expenses. Some examples of these fees include broker trade commissions, trust and custodial expenses, settlement fees, sales charges, transfer taxes, foreign taxes, wire transfer and electronic funds transfer fees, and other fees and taxes on security transactions and custodial accounts. Mutual funds, exchange traded funds and exchange traded notes also charge internal management fees which are disclosed in each fund's prospectus. All such charges, fees and commissions are exclusive of and in addition to Badgley Phelps' advisory fee. Badgley Phelps does not receive any portion of these commissions, fees, costs and expenses. See "Item 12 – Brokerage Practices" for additional information regarding Badgley Phelps brokerage practices.

## **Item 6 – Performance-Based Fees and Side-By-Side Management**

Badgley Phelps does not charge performance-based fees (fees based on a share of capital gains on or capital appreciation of the assets of a client).

## **Item 7 – Types of Clients**

Badgley Phelps currently provides investment management services to individuals, trusts, estates, corporations, pension and profit-sharing plans, charitable institutions, foundations, and endowments. Badgley Phelps requires a minimum client account of \$1,000,000. This minimum may be waived under certain circumstances.

## **Item 8 – Methods of Analysis, Investment Strategies and Risk of Loss**

Badgley Phelps' investment strategies encompass equity only, fixed income only and balanced portfolio management. The following is a review of these strategies.

### **EQUITY MANAGEMENT**

Our equity management goal is to generate competitive results over time by allocating among different equity styles. These styles include Consistent Growth Equity, Relative Value Equity, Small/Mid Cap Equity and International Equity. Each equity style is managed by a team of analysts within our firm that is responsible for stock selection and industry and sector weighting of the equity models. The equities that we consider for investment are all securities that are listed on the major U.S. stock exchanges. When positioning a portfolio, our typical investment horizon is three to five years. For clients that prefer, we also manage equity portfolios that only contain Consistent Growth or Relative Value Equity securities.

### **Consistent Growth Equity**

Badgley Phelps' Consistent Growth Equity investment philosophy maintains that domestic large cap companies with strong and consistent financial characteristics generate competitive results over time. This philosophy is based on academic evidence that the price of a stock will, over time, parallel the trend of the underlying growth rate of the company's revenues, earnings and dividends.

We seek to invest in high-quality, established companies that consistently grow their revenues, earnings and cash flows faster than the broad market. These companies have a track record of outperformance versus their earnings estimates, maintain an attractive valuation and have dominance in their respective marketplace. Our largest weightings consist of companies that we perceive to have the strongest and most viable growth prospects. Sector and industry weightings are the result of our stock selection process, with sector weightings targeted to be within ten percentage points of its relative benchmark, which is the Russell 1000 Growth Index.

Stocks may be eliminated or trimmed from portfolios when the fundamentals of a stock deteriorate or when the valuation of the stock is excessive. To achieve optimal diversification, the Consistent Growth Equity strategy generally holds between 30 to 40 stock positions.



### **Relative Value Equity**

Our Relative Value Equity investment philosophy maintains that out-of-favor companies with attractive valuations – relative to past metrics and their peers – and companies with a catalyst for potential recognition in the marketplace will generate competitive results over time. We look for large cap domestic companies whose stock is selling at attractive valuations relative to their financial characteristics, to their competitors, or to the broader market. These companies may be trading at prices below their fundamental value because the market may not have recognized the value of, for example, a new product introduction, restructuring opportunities, the generation and use of cash, or the skills of the company's management team.

As is the case with our Consistent Growth Equity strategy, we target industry and sector weightings such that the larger weightings are with companies we believe have the best prospects to grow their price. It is our intent that sector weightings not vary more than ten percentage points of the Russell 1000 Value Index, which is the relative benchmark for this strategy. Stocks may be trimmed or eliminated when the valuation of the stock is excessive or when the fundamentals of the stock deteriorate. Like Consistent Growth, the Relative Value Equity strategy generally holds between 30 to 40 stock positions to achieve optimal diversification.

### **Small/Mid Cap Equity**

Our small/mid cap equity investment philosophy maintains that equity investment in a diversified portfolio of small- to mid-sized companies generates long-term appreciation over time. Small/mid cap equities have higher earnings growth rate potential than large companies, are not widely followed by Wall Street analysts and provide for participation in the merger and acquisition cycle. This strategy is presently implemented using several ETFs which we believe to be an efficient method of achieving the desired allocation. As appropriate, mutual funds and other investments may be incorporated within the Small/Mid Cap Equity strategy.

### **International Equity**

With respect to non-U.S. equity opportunities, we generally invest in several ETFs to gain increased diversification and opportunities not available from the stocks of U.S. based companies. Because we are looking for market returns from international economies, these funds are an excellent and inexpensive way to attain this exposure. It is our belief that these international investments should also act to reduce portfolio volatility as their correlation to the U.S. dollar and the U.S. stock market is low.

## **FIXED INCOME MANAGEMENT**

Badgley Phelps uses bonds in client portfolios to meet capital preservation, income and principal stability goals. Once investment objectives and constraints have been established, we select high quality bonds and focus on intermediate-term maturities in an effort to reduce market risk and maximize total return. For clients with large short-term cash positions, we may also be able to structure a fixed income portfolio based on the client's cash flow requirements using the same fixed income investment process.

Our commitment to high-quality investment grade bonds lowers credit risk to our clients as these bonds tend to exhibit a lower degree of price volatility and less default risk. Portfolios are structured around an average intermediate duration that ranges from 3 to 5 years. We believe that capital market history has shown that intermediate-term bonds generate total returns equal to those of long-term bonds, but with less volatility. Once a bond is purchased, we continue to monitor the soundness of the bonds we purchase using a combination of our research efforts, market data, rating agency services and industry publications.

We implement our bond strategy by factoring in our expectations of the position of the bond yield curve. Next we focus on the relative value of the various sectors of the bond market. Finally, we make our selection of the securities that are available in the marketplace which we feel are most advantageous to our clients.

We do not trade in response to anticipated changes in interest rates and we may sell bonds from a portfolio if credit quality deteriorates, the ability of the corporate issuer to service the debt declines, or other opportunities in the market develop that allow us to upgrade portfolio yield, quality and/or liquidity.

### **Taxable Bonds**

For clients with tax-exempt portfolios, we invest in taxable bonds using a broad market strategy that emphasizes sector allocation and security selection. Investments primarily consist of Treasuries, governmental agencies and investment-grade corporate bonds. Treasuries consist of inflation protected (TIPS) and conventional Treasury bonds. High credit quality portfolio risk is managed within distinct tolerance bands for the following categories: duration, yield curve positioning, sector allocation, and security selection.

### **Tax Exempt Bonds**

For clients with taxable portfolios, we invest in high quality municipal bonds with intermediate-term maturities. Generally, these are fixed-rate general obligation bonds, essential service revenue bonds, school enhanced issuer bonds, pre-refunded or escrowed bonds and select insured bonds with strong underlying credit ratings. Diversification in terms of municipal bond quality, coupon rate, and geographic location also reduces portfolio risk.

### **ALTERNATIVE INVESTMENT MANAGEMENT**

Badgley Phelps uses alternative investment securities to further diversify and enhance client portfolios. Certain of these alternative investments offer similar returns over time to equities, but the pattern of returns is different. This makes these investments attractive for diversification purposes. For example, currently one component of the alternative investment strategy known as global resources seeks to use commodity investments worldwide. As such, portfolios can participate in the supply and demand fundamentals of source inputs such as oil, copper, sugar and other products in both developed and developing economies. Broad diversification within the commodity universe is utilized to reduce the volatility of the portfolio. The strategy is implemented using exchange traded funds (“ETFs”) and exchange traded notes (“ETNs”), which offer the opportunity for broad diversification which is tax efficient and low cost.

Another alternative investment strategy is known as multi-strategy which invests in multiple strategies within the same pool of assets. This diversification should help to smooth returns, reduce volatility and decrease asset-class risks. Using ETFs and ETNs, capital may be allocated and reallocated across various strategies in response to various market opportunities, trends, events and risks. Accordingly, the multi-strategy portion of a client’s portfolio may invest in instruments designed to increase in value when the volatility of the stock market rises, may purchase securities structured to rise as the stock market falls, may purchase assets that have a low correlation with stocks and bonds, and may focus on a shorter investment time horizon (concentrating on trends that are projected to persist for six to eight months).

### **CASH**

Badgley Phelps maintains a small percent of each client portfolio in cash and is part of the portfolio’s asset allocation. This cash provides liquidity for client needs and distributions. It may also be used to take advantage of an investment opportunity. Cash is typically invested in a money market fund offered by the client’s custodian which best meets the investment goals of the client’s overall portfolio.

## **BALANCED MANAGEMENT**

Balanced management combines our equity, fixed income, alternative and cash investment management methodologies. Badgley Phelps' balanced strategies are designed to maximize capital appreciation in rising markets with added protection in more volatile markets. The combination of our equity, fixed income, alternatives and cash investing affords Badgley Phelps the ability to provide a prudent, strategic asset allocation tailored to our clients' investment objectives, cash flow needs and risk profile.

As part of our investment discipline, we actively monitor client portfolios and routinely rebalance the portfolios to their target portfolio asset class weightings. This discipline forces the sale of outperforming assets and the simultaneous purchase of less expensive investments.

## **RISK MANAGEMENT**

Risk management is an important aspect to consider as investors. Investment in any of the securities described above involves risk which could cause an investor to lose money. We ask that our clients work with us in defining their individual tolerance for risk.

Some of the material risks when investing in stocks include the possibility that stock prices will decline. Stock markets tend to move in cycles, so there is the possibility that one of our equity investment styles could trail the returns from the overall stock market. Stock securities of foreign stocks are subject to the possibility that world events and events in the foreign countries where the companies are located (such as political upheaval, financial troubles, or natural disasters) will adversely impact their price. Fluctuations in the foreign exchange rate of the U.S. dollar could also have a negative impact on foreign stocks. The prices of foreign stocks and the prices of U.S. stocks have, at times, moved in opposite directions.

Bond investments are subject to the chance that bond prices overall will decline due to rising interest rates. If interest rates fall, income generated from bond investments may also fall. Bonds are also subject to credit risk, which is the possibility that the bond issuer will be unable to make interest or principal payments, or that negative perceptions of the issuer's ability to make such payments will cause the price of that bond to decline. If a bond is callable, any price appreciation above the bond's call price could be lost, which could result in reinvesting the unanticipated proceeds at lower interest rates.

Another risk component that investors need to be prepared for is manager risk. This is the possibility that security selection or focus on securities in a particular sector, category, or group of companies could result in underperformance to relevant benchmarks or other securities.

## **Item 9 – Disciplinary Information**

Registered investment advisers are required to disclose all material facts regarding any legal or disciplinary events that would be material to your evaluation of Badgley Phelps or the integrity of Badgley Phelps' management. There are no legal or disciplinary events related to Badgley Phelps and its supervised persons that are material to a client's or prospective client's evaluation of Badgley Phelps' advisory business or the integrity of its management.

## **Item 10 – Other Financial Industry Activities and Affiliations**

Badgley Phelps is not actively engaged in business other than its investment advisory practice.

## **Item 11 – Code of Ethics**

Badgley Phelps requires that its employees follow a Code of Ethics. This Code of Ethics incorporates certain general fiduciary principles, guidelines and procedures designed to prevent actual or potential conflicts of interest between our clients and our employees' personal security transactions.

The guidelines included in the Code of Ethics require disclosure and annual reporting of certain personal security holdings. Additional requirements include pre-approval or pre-clearance procedures for certain security transactions, quarterly reporting of required security transactions, and the prohibition of certain types of security transactions. The Code of Ethics also covers other standards of business conduct including the acceptance of gifts and entertainment, and pre-approval to serve on the board of public companies. All employees of Badgley Phelps must acknowledge the terms of the Code of Ethics annually.

For purposes of this policy, employees are not required to report security investments that include securities issued by the U.S. Government, certain open-end mutual funds, and certain other short-term debt securities such as bankers' acceptances, bank certificates of deposit, and commercial paper. All other securities which our employees may wish to purchase or sell,

including the same securities we recommend to our clients, must be transacted under certain guidelines. Accordingly, we have adopted the following guidelines to prevent any conflicts of interest arising from our employees' personal trading practices and the security recommendations and transactions we place on behalf of our clients:

**Pre-clearance of Securities Transactions.** Advance clearance is required for security transactions (as defined under this policy) in which an employee has beneficial ownership. This request is approved or disapproved based on the compliance criteria outlined in the Code of Ethics. Factors considered include the type of security transaction, whether the security is on the firm's buy list, whether the security transaction is for a new or existing security holding, and the timing of the transaction in relation to certain client transactions. Certain transactions are prohibited. These include, but may not be limited to, initial public offerings, certain private placements, and certain short-term trades.

**Disclosure and Annual Reporting of Personal Securities Holdings.** Employees of Badgley Phelps are required to disclose, upon commencement of their employment and on an annual basis thereafter, all their personal securities holdings as defined by the Code of Ethics.

**Quarterly Reporting of Securities Transactions.** Each employee of Badgley Phelps must submit a report detailing (a) all security transactions which were executed during the current calendar quarter for their personal account or any account in which they have a beneficial interest; and (b) whether the employee opened a new brokerage account during the quarter. This report is submitted for review no later than ten days after the end of the calendar quarter.

**Restricted Security Transactions.** Certain restrictions regarding the timing of certain security transactions apply to our firm's employees. Employees who wish to purchase or sell securities which are also being bought and sold for certain clients of the firm may not always be able to execute this transaction. From time to time, "black out" time periods may be announced on certain anticipated client transactions which would restrict employees from trading in these securities.

Badgley Phelps employees may, from time to time, buy or sell securities for themselves that are also being transacted or recommended to our clients and these transactions must be approved in advance as described above. Additionally, the firm's employees may enter into personal

transactions of securities which are not deemed appropriate for recommendation to our clients. Badgley Phelps' Code of Ethics has been adopted to prevent potential conflicts of interest or the appearance of a conflict of interest between our firm's clients and our employees' personal transactions. A copy of our Code of Ethics is available to our clients and prospective clients upon request.

## **Item 12 – Brokerage Practices**

### **Broker Selection and Trading Process**

Badgley Phelps endeavors to select brokers who secure best execution for our clients. Unless the client directs us to execute transactions with a broker of preference, Badgley Phelps selects brokers for client transactions.

When executing client transactions, Badgley Phelps allocates equity and fixed income trades to brokers after making a good-faith judgment that the transaction will be executed in the best interest of the client. The criteria used for selecting brokers may include the quality and reliability of the execution of each trade. It also includes a determination that the commissions paid for these transactions are reasonable in relation to the value of the brokerage and research services provided to our clients and our firm. For instance, execution capability, promptness of execution, complexity of the trade, research coverage, financial responsibility of the broker, administrative resources and broker responsiveness are some of the factors we consider when evaluating and selecting a broker. These are factors we consider in addition to commission rates.

Commission rates are negotiated with each broker selected by Badgley Phelps. It is our intent to negotiate commission rates that are reasonable in relation to the value of the research and brokerage services provided, including best execution. We believe that the brokerage fees paid by our clients represent fair payment for execution capability and the value of the research provided which may not otherwise be available if a broker was selected solely on the basis of commission costs. We base our transaction placement decisions on an evaluation of the factors noted above, and maintain a record of transactions placed by us on behalf of our clients.

Security orders may be placed separately or aggregated with other client trades. For trades that are aggregated, procedures are in place that are designed to ensure that no client receives preferential trading at the expense of another client. Client trades that are aggregated, or combined, with other client trades of the same security are done for the purpose of achieving a

better commission and/or better execution for the clients. Clients in an aggregated trade receive the same price per share or unit, but may pay a different commission if they have directed brokerage to a particular broker. If more than one price is paid for a security, each client will receive the average price for that trade. If aggregated trades are only partially filled, the trades are allocated to each client account on a prorata basis based on the original size of the client's order. In addition, if an aggregated trade that is only partially filled is executed in more than one lot at different prices, an average price would be calculated such that all client accounts participating in the aggregated trade would receive the same execution price.

When purchasing bonds for clients who do not have broker-directed arrangements or whose broker-directed accounts permit bonds to be traded with other brokers, offers are sought from brokers who have appropriate inventory or who offer a particular bond. Depending on the type of bond, comparisons may be made between the bond being offered and bonds with similar characteristics currently trading in the market. Characteristics which could be evaluated include credit name, coupon, maturity, call/put options, underlying credit rating, credit enhancement, and corporate or municipal sector. The broker's offer is then evaluated and either accepted or rejected.

When selling bonds, Badgley Phelps strives to achieve best execution by obtaining several bids, as is reasonably possible, taking into consideration current market conditions, the characteristics of the bond, and the broker's price bid. All of these factors are considered when selecting the winning bidder. For bond purchases and sales in broker directed accounts, the bond trade is placed with the client-designated broker. In this circumstance, the bond purchased may or may not be from the broker's inventory and the trade price of the bond sale or purchase may or may not be in line with the institutional bond market.

Badgley Phelps also has trade error resolution policies in place which are designed to detect and settle trade errors such that the client is not disadvantaged by, and the firm does not benefit from, the error. Any trading error resulting in a monetary loss to a client is promptly reimbursed to the client.

### **Client-Directed Brokerage**

For those clients who wish us to direct their transactions to a specific broker, Badgley Phelps will maintain this client-broker relationship so long as the client directs us to do so. In this situation, Badgley Phelps may not be able to negotiate commissions on the client's behalf and/or may not be able to aggregate trades with the trades of other clients. The client who directs



Badgley Phelps to trade with a specific broker may not receive best execution since directed brokerage could result in higher commissions, greater spreads, less favorable net prices and less favorable execution prices. Additionally, the client who requests directed brokerage may restrict Badgley Phelps from receiving research-related products and services which may be available from the brokers selected by Badgley Phelps.

Additionally, some clients of our firm are engaged in wrap fee arrangements with certain independent consultants whereby, in consideration of a fee paid by the client, the consultant will provide services to the client which may include custody, brokerage, investment management and/or performance measurement.

### **Agency Cross Transactions**

Badgley Phelps does not enter into agency cross transactions for any of its client accounts.

### **Research and Soft Dollars**

Badgley Phelps receives research services and products from certain brokers. Brokerage commissions used to acquire research services and products are known as soft dollars. Federal securities rules provide a safe harbor which permits clients of Badgley Phelps to pay more than the lowest commission once Badgley Phelps has determined in good faith that the commission paid is reasonable in relation to the brokerage and research services provided. This safe harbor allows that in seeking best execution, the determining factor is not the lowest possible commission but whether the transaction takes into account other factors as well. These factors include execution price, execution capabilities of the broker, size of the transaction, other transaction costs besides commissions, complexity of the trade, the operational capabilities of the broker and the research services provided. These are factors considered in addition to the commissions paid. Therefore, to attain best execution, it is possible that a client may or may not pay a higher commission when transactions are executed through these soft dollar brokers.

These services and products are used to benefit and service all of our client accounts and are paid for in full or in part with soft dollars. Soft dollar benefits are not proportionate to the soft dollar credits the account generates.

As fiduciaries, Badgley Phelps realizes there could exist a potential conflict of interest in its decision to use soft dollars to acquire research services and products. To ensure that this conflict is minimized, Badgley Phelps' trading team has developed quantitative and qualitative criteria

used to evaluate each broker's ability to procure best execution. This criteria is periodically evaluated and reviewed with our chief compliance officer to ensure that our best execution standards are met with all of the brokers we use, including our soft dollar brokers.

The services and products provided with soft dollars include proprietary and third-party research. Proprietary research is research created and provided by certain brokerage firms. This research includes economic, industry, corporate strategy, fundamental and technical reports and analyses. We have no pre-planned agreements or understandings with brokers regarding the amount of brokerage required to procure proprietary research.

Third party research services are also used by our firm. This is research that originates from an entity separate from the broker that actually provides the transaction execution services. These research products and services may include electronic security research reporting systems, portfolio risk management and fundamental analysis tools, portfolio management and trading system, security pricing and indices reporting services, and performance measurement services. For these third-party research services, Badgley Phelps has agreed to a conversion ratio with the executing brokers whereby a portion of every commission dollar generated through security transactions is credited to the cost of providing this research service. Badgley Phelps has contracted with several brokerage firms to provide these third-party research services. These brokerage firms are Capital Institutional Services and Charles Schwab & Co., Inc.

Our firm has determined that certain of these third-party products and services serve other functions that are not related to the research process. For these "mixed-use" products and services, Badgley Phelps has made a good faith attempt to allocate the anticipated use of the product to its research and non-research components. The percentage of the service or product which is used as research is paid for using commission dollars while the remaining portion is paid directly by Badgley Phelps. Mixed-use products and services can include the portfolio management and trading system, security and indices pricing services, electronic security research reporting systems, and performance measurement services.

## **Item 13 – Review of Accounts**

Most investment advisory accounts are formally reviewed by the client's investment manager once every three months while other accounts may be reviewed monthly or at other than three-month intervals as established from time to time with the client. As part of the review process,

advisory accounts are routinely rebalanced to target portfolio asset allocations previously agreed upon with our clients.

Badgley Phelps currently has a total of eleven investment managers who are responsible for reviewing investment advisory accounts. Some investment advisory accounts are reviewed by more than one investment manager. Three associate investment managers also work with several of our investment managers.

In the event there is adverse news on a particular security or one of our investment teams makes a decision regarding security selection, all accounts owning that security may be reviewed even though a review is not scheduled. Investment managers are expected to restrict their security purchase recommendations to the approved security buy list/model portfolios and to follow approved firm investment philosophy and strategy within the framework of the client's needs and circumstances.

Portfolio appraisal review reports are prepared and sent to clients on a scheduled basis, typically once every three months. These reports are all written and generally consist of a portfolio commentary and review letter which summarizes recent market developments, discusses the portfolio's performance and/or asset allocation, and provides summary information regarding recent transactions. Additional reports include the portfolio summary report and portfolio appraisal report which detail the individual securities held in each portfolio and also may include summary information of each asset class held in the portfolio, portfolio performance and recent purchases and sales. Based on their individual circumstances and requirements, clients may also request other reports such as realized and unrealized gain and loss reports, and income and expense reports. Reports are available to clients monthly, quarterly and/or annually, based on the clients' needs or preferences.

## **Item 14 – Client Referrals and Other Compensation**

### **Third-Party Investment Advisory Agreements**

From time to time, Badgley Phelps has entered into agreements with other financial service firms to provide discretionary separate account portfolio management for certain clients of these firms. Portfolio management services offered include equity only, fixed income only and balanced portfolio management as described above. Badgley Phelps and the financial service firms have shared as well as separate responsibilities in the supervision and management of these accounts.

Generally, these accounts have a minimum account size of \$250,000. Badgley Phelps directly bills these clients for its investment advisory fee. The basic fee schedule for portfolio management services provided under these agreements is 0.50% for equity and balanced accounts, and 0.30% for fixed income only accounts. Generally, fees for accounts under these agreements are not negotiable.

Badgley Phelps' advisory fees may represent only a portion of the total fee paid by these clients since the client may also be paying a separate fee to the other financial service firm as payment for their portion of the services provided to the client.

### **Referral Agreements**

Badgley Phelps has signed an Investment Manager Service Agreement with Charles Schwab & Co., Inc. ("Schwab") to participate as an investment manager in the Schwab Adviser Network program. From time to time, Schwab representatives may identify and refer potential clients to Badgley Phelps who may wish to hire Badgley Phelps as their investment manager. Under this Agreement, Badgley Phelps will pay a referral fee to Schwab for those clients that hire Badgley Phelps. The fee paid by Badgley Phelps is either a percentage of the investment advisory fee or a percentage of the value of those assets in the client's account. These clients are notified in writing of the agreement between Badgley Phelps and Schwab in accordance with applicable securities regulations. These clients do not pay Badgley Phelps a higher fee than they would otherwise pay as a result of the Schwab Agreement.

In addition, Badgley Phelps has signed a Referral Agreement with KMS Financial Services, Inc. ("KMS"). From time to time, KMS may identify and refer potential clients who may wish to hire Badgley Phelps as their investment manager. Under this Agreement, Badgley Phelps pays a referral fee to KMS for those clients that hire Badgley Phelps. This fee is a percentage of the client's investment advisory fee. These clients are notified in writing of the solicitation agreement between Badgley Phelps and KMS in accordance with applicable securities regulations. These clients do not pay Badgley Phelps a higher fee than they would otherwise pay as a result of the KMS Agreement.

## **Item 15 – Custody**

If a client requests that we recommend a broker for the safekeeping of securities, we base our recommendations on the compatibility of services needed by and provided for the client, the financial strength of the broker, and the factor of confidentiality for the client. In all cases we recommend that all of our clients select a qualified custodian. We currently recommend to the majority of our clients that they consider using Schwab Institutional or Schwab Private Trust Services as the custodian for their investment accounts. We base this recommendation, in part, on Schwab's ability to provide reliable custody and trust services as well as efficient trading capabilities. Other factors considered include Schwab's demonstrated ability to provide efficient servicing and reliable reporting, to handle complex trading requirements and to provide our clients with low-cost custody options. All custodial fees and compensation payable to Schwab are reviewed with the client prior to opening the account. Ultimately, it is up to the client to decide whether to custody assets at Schwab or with any other custodian.

Schwab makes available to Badgley Phelps products and services that benefit our firm and benefit our ability to service our mutual client accounts. These include account access technology that provides access to client account data, facilitates trade execution, and provides market research. Other services made available by Schwab include services intended to help manage and further develop our firm's business enterprise. These include business consulting, publications and conferences on practice management, succession planning, compliance, operations and trading. Schwab has made available and arranged payment for certain of these conferences, training and research services/products. These are in addition to the soft dollar arrangement Schwab has with Badgley Phelps and a new business referral program which are both discussed elsewhere in this document.

The clients' qualified custodian sends quarterly, or more frequent, account statements directly to them. Badgley Phelps urges our clients to carefully review these statements and compare them to the account reports that we send to them. Our reports may vary from our clients' custodial statements based on accounting procedures, reporting dates or pricing sources of certain securities.

Badgley Phelps does not have custody of client funds as defined by the federal regulators. As described above under "Item 5 – Fees and Compensation," clients may authorize Badgley Phelps to deduct our advisory fee directly from the clients' custodial account. Because the custodian does not calculate the fee amount, we encourage our clients to verify the accuracy of the calculation.

Additionally, several of our investment managers have been appointed trustees of accounts in which the investment manager has a personal or family relationship with the beneficiary, decedent or grantor of the trust.

## **Item 16 – Investment Discretion**

Badgley Phelps usually receives discretionary authority from the client at the outset of an advisory relationship to select the identity and amount of securities to be bought or sold. In all cases, however, such discretion is to be exercised in a manner consistent with the stated investment objectives for the particular client account.

If the client prefers, Badgley Phelps may also manage client portfolios on a non-discretionary basis. Under a non-discretionary investment management arrangement, Badgley Phelps makes investment recommendations to the client and the client makes all decisions with respect to the investment of the account.

When selecting securities and determining amounts, Badgley Phelps observes the investment policies, limitations and restrictions of the clients for which it advises. We prefer that all investment guidelines and restrictions be provided to Badgley Phelps in writing.

## **Item 17 – Voting Client Securities**

Badgley Phelps has adopted Proxy Voting Policies and Procedures to guide proxy voting on behalf of the clients for whom we vote proxies. The guidelines are not exhaustive and do not cover all potential voting issues because proxy issues and the circumstances of individual companies are varied. As a result, there may be circumstances when proxy votes cast by Badgley Phelps on behalf of our clients are not in strict adherence to these guidelines. Nevertheless, proxy voting is generally cast in adherence to the guiding principles of the proxy policy.

Badgley Phelps has established a Proxy Committee which is responsible for proxy voting. Proxy votes cast on behalf of our clients should be cast by us in a manner consistent with the best interests of the client. Badgley Phelps has established the following guiding principles to assist in analyzing each proxy issue and in providing a framework for decision-making:

- Promote accountability of a company's management and its Board of Directors to its shareholders;
- Align the interests of management with those of the shareholders; and,
- Increase disclosure of a company's business and operations.

It is anticipated that the Proxy Committee may evaluate proxy issues using information from diverse sources, including Badgley Phelps' investment managers and research analysts, company management, shareholder groups, and independent sources. To further promote both the Proxy Policy and these voting guidelines, Badgley Phelps has established voting principles for certain matters likely to come to a vote.

Badgley Phelps will vote proxies or a certain proxy for clients when directed in writing to do so by the client. If the client is subject to ERISA and the plan has not specifically withheld the proxy voting responsibility to a named fiduciary, Badgley Phelps will vote the proxies. Otherwise, Badgley Phelps does not vote proxies for client accounts. To facilitate the voting of client proxies, Badgley Phelps uses the ProxyEdge electronic voting service which manages the process of voting, tracking, reporting and record maintenance of our firm's proxy voting guidelines and principles.

If Badgley Phelps is not directed to vote client proxies, the client's custodian or transfer agent will send proxy statements directly to the client or as per the client's direction. If there is a question regarding a particular proxy solicitation, clients may contact their investment manager to review this matter.

Clients may obtain a copy of Badgley Phelps' proxy voting policies and procedures upon request. Clients may also obtain information from Badgley Phelps about how we voted any proxies on behalf of their account(s) upon request.

## **Item 18 – Financial Information**

Registered investment advisers are required in this Item to provide certain financial information or disclosures about Badgley Phelps' financial condition. Badgley Phelps has no financial requirement that impairs its ability to meet contractual and fiduciary commitments to clients, and has not been the subject of a bankruptcy proceeding.