

# BADGLEY+PHELPS

WEALTH MANAGERS

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

### **Badgley Phelps Wealth Managers**

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March 30, 2018

Form ADV Part 2, which is comprised of Part 2A and 2B, 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 Wealth Managers.

Badgley Phelps Wealth 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 and wealth manager.

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.

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).

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**

When specific material changes occur at our firm since the last annual update of our brochure, we are required to disclose these changes here.

This annual update of our brochure, dated March 30, 2018, includes an updated amount of our assets under management. Other clarifications were made to the description of our alternative investment strategy and custody. Other minor revisions were made elsewhere in our brochure.

A complete copy of our brochure is available at any time upon request without charge. You may 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).

**Item 3 -Table of Contents**

Item 1 – Cover Page .....	1
Item 2 – Material Changes .....	2
Item 3 – Table of Contents .....	3
Item 4 – Advisory Business .....	4
Item 5 – Fees and Compensation .....	6
Item 6 – Performance Based Fees and Side-By-Side Management .....	7
Item 7 – Types of Clients.....	7
Item 8 – Methods of Analysis, Investment Strategies and Risk of Loss .....	7
Item 9 – Disciplinary Information .....	13
Item 10 – Other Financial Industry Activities and Affiliations .....	13
Item 11 – Code of Ethics .....	13
Item 12 – Brokerage Practices .....	15
Item 13 – Review of Accounts .....	18
Item 14 – Client Referrals and Other Compensation .....	19
Item 15 – Custody .....	21
Item 16 – Investment Discretion .....	22
Item 17 – Voting Client Securities .....	22
Item 18 – Financial Information .....	23

#### Item 4 – Advisory Business

Badgley Phelps Wealth 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 35 employees, of which 15 are also shareholders of our firm. Significant owners of Badgley Phelps are J. Kevin Callaghan and Steven C. Phelps.

A wealth 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, risk tolerance, return objectives, tax circumstances and income needs. In most 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 by notifying their wealth manager. At our clients' request, we will also work with their other professional advisors, such as attorneys and accountants, to provide assistance regarding tax, estate planning and other issues that can impact our client's financial well-being.

Our investment services 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 either strong and consistent earnings growth or attractive valuation. Medium to large capitalization stocks and American Depositary Receipts ("ADRs") registered on the U.S. stock exchanges with a core growth or relative value bias are selected within 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 a diversified portfolio of high-quality, short- and intermediate-term bonds. Our focus is on client specific solutions based on the client's tax rate and

portfolio guidelines. 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 balanced to this target allocation ratio. Typically, accounts are reviewed for asset allocation rebalancing at least once every three months.

Badgley Phelps manages client assets on a discretionary as well as non-discretionary basis. As of December 31, 2017, the market value of client assets managed on a discretionary basis was \$2,300,787,662 and \$189,079,047 for non-discretionary assets, for total regulated assets under management of \$2,489,866,709.

## Item 5 – Fees and Compensation

Badgley Phelps' standard advisory fee schedules for new accounts are as follows:

<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 wealth and 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 investment portfolio(s) of \$1,000,000 per client household but this minimum may be waived under certain situations. 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 option to pay our invoices directly upon receipt. Additionally, with client authorization, Badgley Phelps may deduct the advisory fee from the client's account by directly billing the client's custodian. Each fee payment deducted from the client's custodial account is reported on the client's account statement prepared by and sent from the client's custodian. Badgley Phelps urges our clients to carefully verify the accuracy of each invoice since their custodian may not verify the accuracy of our fee calculation.

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 when terminating. The client's final invoice is adjusted prorata to the termination date with reimbursement to the client or the client's custodial account 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, regulatory fees, exchange fees, legal fees, accounting fees, and other related costs and expenses. Some examples of these fees include broker trade commissions, trust and custodial expenses, attorney and estate fees, accounting and tax preparation fees, 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. Additionally, mutual funds, exchange traded funds and exchange traded notes 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 payment resulting from 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, which are 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. We require a minimum investment portfolio(s) of \$1,000,000 per client household but this minimum may be waived under certain situations.

#### **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 uses four 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 research 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 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 our belief 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 stock 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.

### **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 as 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. ETFs invested in international economies may be from countries that have developed economies and countries whose markets are still emerging. It is our belief that these international investments may act to reduce portfolio volatility as their correlation to the U.S. stock market can vary.

### **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.

Bond portfolios are structured to reflect our views on the economy, fiscal and monetary policy, political developments, credit fundamentals, and bond valuations as well as our experience in managing the many technical factors impacting the market. The core of our decision-making process is focusing our

research and credit analysis on sector, issuer, security, quality and structure selection and not on factors such as taking aggressive interest rate bets or excessive credit risks. We utilize a wide variety of research and publicly available information to guide our decisions.

We may sell bonds from a portfolio if credit quality deteriorates, the ability of an issuer to service the debt declines, or other opportunities in the market develop that allow us to upgrade portfolio quality, yield, and/or liquidity. Investment monitoring and rebalancing are ongoing aspects of our fixed income portfolio management process.

### **Taxable Bonds**

For clients with tax-exempt portfolios, we invest in taxable bonds with intermediate-term maturities 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 may 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. Based on market conditions, alternative investment management can include the investment in multiple strategies within the same pool of assets. We believe that diversification into these alternative strategies helps to smooth returns, reduce volatility and decrease asset-class risks. Using ETFs and ETNs, capital may be allocated and reallocated across strategies in response to various market opportunities, trends, events and risks. Accordingly, based on market conditions, this 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 eighteen months). Some of the key areas that we consider as tactical opportunities include equity, fixed income, hedged markets, commodities, real estate and foreign exchange.

## **CASH**

Badgley Phelps generally maintains a small percent of each client portfolio in cash which is also 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 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. Our philosophy is that a balanced strategy may 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 monitor client portfolios and 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 matter for investors to consider. All investments have risks associated with them. Investment in any of the securities described above involves risk which could cause an investor to lose money. We do not warrant or guarantee any particular level of account performance or that the account will be profitable over time. We use our best judgment and good faith efforts in rendering services to our clients and we ask that our clients work with us in defining their individual tolerance for risk. And, while risk is unavoidable, it can be managed using certain tools such as portfolio diversification.

Some of the material risks when investing in stocks include the possibility that stock prices will decline. For instance, stock markets tend to move in cycles, so it is possible that one of our equity investment styles could trail the returns from the overall stock market. Foreign stocks are subject to the possibility that world events and events in their home country (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 possibility that bond prices 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.

The following list summarizes various types of investment risk:

- Capital Risk. The risk that the investor will not fully recover his/her entire investment. Speculative investments such as options have a high degree of this type of risk, while quality short-term investments such as Treasury bills typically have minimal capital risk.
- Selection Risk. The risk of choosing a security that will perform worse than other available securities.
- Timing Risk. The risk of buying or selling at an inopportune time, thus limiting profit or incurring a loss.
- Legislative Risk. The risk that future legislation will impact today's investment decisions. International, federal, state and local laws or regulations may change without notice, possibly impacting a security's performance.
- Liquidity Risk. The risk that the security holder will have a difficult time selling should there be a decline in the quality or the desire by the marketplace for this particular investment.
- Market Risk. The risk that the value of a security will decline due to overall market conditions, not by any fault of the issuing company.
- Credit Risk. The risk that the issuer may become unable to pay interest and/or principal when due on fixed income securities. U.S. government securities are the least likely to default on payments, while "junk" bonds have a high degree of credit risk.
- Inflationary Risk. The risk that inflation will reduce the purchasing power of the U.S. dollar over time. Equity securities tend to provide the best protection against this type of risk, while bonds are more susceptible. Interest income earned by bonds is fixed plus there also exists the possibility of long-term exposure to rising inflation for bonds with longer maturities.
- Interest Rate Risk. The risk that, as interest rates rise, a bond investor's holdings will decline as more attractive offerings enter the market. The longer the bond maturity, the greater the risk. Some stocks may also be susceptible to this type of risk if the company's borrowings are high. This will increase the company's interest expense costs which could decrease the company's stock price.
- Reinvestment Risk. The risk that a bondholder will be unable to reinvest interest payments at a rate equaling the yield-to-maturity.
- Call Risk. The risk that a bondholder will have their bonds called away by the issuer if prevailing interest rates decrease below what their bond is paying. The bondholder would then have to invest in bonds that likely would not pay as much interest.

### **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 wealth management and 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 prohibits insider trading and participation in initial public offerings. It also establishes guidelines regarding investment clubs, participation in limited or private offerings, plus 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 policies and procedures 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 without charge.

## **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. Additionally, 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 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, any client instructions regarding the sale 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.

### **Trading Errors**

If Badgley Phelps is responsible for a trading error, it is our policy to correct the error and cover the cost of the error. When a trading error occurs, we will correct the trade depending on the facts and circumstances associated with the error at the time we discover the error.

In most cases, we will correct trade errors through the broker-dealer's trade error desk which effectively cancels the original trade in the client's account and replaces it with the correct trade. If there is a cost to the client and/or the broker-dealer associated with this correction, Badgley Phelps pays these costs. In some cases, an error can result in a gain. In this case we will notify the client to review the circumstances and ask whether the client would like to retain the gain or reverse the trade through the broker-dealer's trade error desk. If the trade is reversed through the trade error desk, the gains may be donated to charity by the broker-dealer depending on the rules and procedures of the executing broker-dealer's trade error desk.

It is also possible that we may correct a trade error directly in our client's account by placing a new trade instead of cancelling the original trade as described above. If this results in a gain, such gain is retained by the client since the error correction occurs directly in the client's account. In this situation, the client could be responsible for any taxes associated with this transaction. On the other hand, if the trade correction results in a loss, we would reimburse the client directly for the costs arising from this error.

### **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 or financial service firms 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 Charles Schwab & Co., Inc. to provide these third-party research services.

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 wealth 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 twelve wealth and investment manager professionals who are responsible for reviewing investment advisory accounts. Some investment advisory accounts are reviewed by more than one wealth manager. Three associate wealth managers also work with several of our wealth 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. Wealth 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. However, from time to time, a client may own a security that is not on our approved buy list. This security may continue to be held in the client’s portfolio and the wealth manager will determine

whether the security will be managed on a supervised or non-supervised basis. Wealth managers take responsibility for all securities managed on a supervised basis.

Portfolio review reports are prepared and sent to clients on a scheduled basis, typically once every three months. These reports generally consist of: (1) a portfolio commentary and review letter which summarizes recent market developments and provides summary information regarding recent transactions; and (2) portfolio summary and appraisal reports which detail the individual securities held in each portfolio and include summary information of each asset class held in the portfolio, plus portfolio performance and recent transactions. Clients may also request other reports such as realized and unrealized gain and loss reports, or income and expense reports. Reports are available to clients monthly, quarterly and/or annually, based on the clients' needs or preferences.

Financial plans may be reviewed and updated at various times, depending upon the nature and terms of our clients' needs and financial circumstances. These reviews are conducted to confirm that the recommendations and investments we make are done in accordance with our clients' investment plans and financial goals.

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

### **Sub-Advisory Agreement**

Badgley Phelps has entered into a sub-advisory agreement with Barwick & Partners, Inc. ("Barwick"), a registered investment adviser located in Seattle, Washington, to provide investment advisory services for Barwick client accounts. Prior to allocating any client accounts to Badgley Phelps, Barwick determines that the client accounts are suitable for investment advisory services in accordance with our investment advisory strategy. As sub-adviser, Badgley Phelps provides services to these accounts as directed by Barwick, including investment advisory, reporting, administrative, and supervisory services. Under the sub-advisory agreement, Badgley Phelps receives a negotiated fee directly from the clients. This fee is computed on the market value of assets less non-supervised assets, and the clients are billed once every three months. Badgley Phelps' sub-advisory fee represents only a portion of the total fee paid by these clients since the client also pays, at a minimum, a separate fee to Barwick.

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

From time to time, Badgley Phelps has entered into agreements with other financial service firms to provide separate account investment management on a discretionary basis 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. Fees for accounts under these agreements usually are not negotiable. These clients receive all portfolio reports from the third-party financial service firms.

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 Agreement**

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 wealth 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.

### **Other**

From time to time, we receive referrals from our existing clients as well as other professional service providers, such as accountants and attorneys. We do not have any formal referral agreements with these individuals and do not formally compensate these individuals for the referral. We are aware that reciprocating the referrals we receive from these professional service providers could lead to a conflict of interest. When asked for referrals to professional service providers, we refer our business and that of our clients in as unbiased a way as possible by providing multiple names, when available, for each referral.

### **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 require that all of our clients select a qualified custodian. We currently recommend to the majority of our clients 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, handle routine as well as complex trading requirements and provide our clients with low-cost custody options. An estimate of potential custodial fees and compensation payable to Schwab and several other custodians is available for review 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 another custodian.

Schwab makes available to Badgley Phelps products and services that benefit our firm and improve our ability to service our mutual client accounts. These products and services are in addition to the soft dollar arrangement Schwab has with Badgley Phelps and the new business referral program which are both discussed elsewhere in this document. These additional products and services include technology that allows us to electronically access client account data and facilitates trade execution as well as the processing of client fee payments. Other services made available by Schwab include research, pricing and access to market data, plus services intended to help manage and further develop our firm's compliance program and business enterprise. These include business consulting, publications and conferences on practice management, succession planning, marketing, compliance, operations and trading. Schwab has made available and arranged payment for certain conferences, training and research services/products. Occasional business entertainment is also offered to our employees.

The clients' qualified custodian sends quarterly, or more frequent, account statements directly to our clients. For those custodians that can deliver account statements electronically or via paper, it is up to each client to select the preferred delivery method. The custodian sends a copy of these statements to Badgley Phelps and may also electronically transmit daily transactions to us which are used to update and reconcile our portfolio reporting system. Badgley Phelps urges our clients to carefully review the custodian statements and compare them to the account reports that we send to them. Our reports may vary from our clients' custodial statements due to a difference in accounting procedures, reporting dates or valuation methodologies/pricing sources. We encourage our clients to contact us and their custodian if they identify any discrepancies between the custodian's statements and our account reports.

While Badgley Phelps does not act as a qualified custodian, we do have custody of client funds as defined by the federal regulators under certain circumstances. One of these is when a client signs a Standing Letter of Authorization directing the client's custodian to accept the authorization of Badgley Phelps to process certain securities and funds transfer requests on behalf of the client. Additionally, as described above under "Item 5 – Fees and Compensation," clients have the option to give written authorization to Badgley Phelps to deduct our advisory fee directly from the clients' custodial account. A copy of the billing invoice is sent to each client and we encourage our clients to verify the accuracy of the calculation because the custodian does not calculate the fee amount. Several of our wealth managers have also been appointed trustees of accounts in which the wealth 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 specific securities and the quantities that are bought or sold. In all cases, however, such discretion is to be exercised in a manner consistent with the stated investment objectives or asset allocation 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 the 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 that we advise. We prefer that all investment guidelines and restrictions be provided to Badgley Phelps in writing and request that our clients notify us promptly of any changes in their financial circumstances or investment objectives.

### **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 our clients. 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 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 evaluate proxy issues using information from diverse sources, including Badgley Phelps' wealth 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. To facilitate the voting of client proxies, Badgley Phelps uses the ProxyEdge electronic voting service which manages the process of voting, tracking, reporting and maintaining the records 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 wealth manager to review this matter.

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

#### **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 any bankruptcy proceeding.