To: Samantha Kravitz

From: Josh Yager

RE: Governance Audit for The Elizabeth Smith Trust

Date: November 15, 2018

In his March 28th report, Mr. Allen Johnson, Guardian *Ad Litem* for Elizabeth Smith, reported several concerns about the investment performance of the trust. Specifically, Mr. Johnson wrote, "The principal role of a trustee is to manage property and finance for the sole benefit of the identified beneficiary(ies) of the trust. Here, I have some concern regarding Martha's fulfillment of this duty…"[1]. Again, during the July 11, 2018 hearing, Mr. Johnson said, "Because I think there is a possibility of a surcharge, I am asking for the court to withhold approval of those fees…"[2].

Anodos[3] has been engaged by Samantha Kravitz, the attorney for the trustee Martha Howe, to evaluate if the actions of her client fulfilled her duties of care as trustee under the California Prudent Investor Act.

We have conducted the following investigations: (1) reviewed the state statute which defines a trustee's duties of care, (2) reviewed the trust document to understand the trustee's powers and the trust purposes, (3) reviewed the trustee's compliance files for records of communication, work product and processes related to investment governance, (4) interviewed the trustee, (5) interviewed a representative of the investment advisor, Archibald Capital, (6) reviewed the investment statements and transaction history provided by the independent custodians (Fidelity and TD Ameritrade) for the period in question and (7) conducted independent research of the advisor's SEC filings. Based on this review we have reached the following conclusions:

1) The trustee is familiar with her duties of care as a trustee.
2) The trustee has established and executed a series of governance procedures as part of the fulfillment of her duties of care.

[1] See "Report of Guardian Ad Litem Re Second and Current Account and Report of Trustee, and the Multiple Related Petitions" Page 10

[2] Transcript of July 11, 2018 Hearing, Page 4

[3] See Exhibit B.

3) The trustee's decision to establish a conservative investment mandate was reasonable given the need to provide reliable funding for services necessary to "maintain a level of human dignity and humane care."
4) In our professional opinion, the trustee acted prudently and in good faith in the selection, delegation and monitoring of the investment advisor, Archibald Capital.

Specifically, following are the trustee's duties of care as codified in the California Prudent Investor Act and our evaluation of their fulfillment:

Duty to Prudently Administer - §16047(a): The code directs, ***"A trustee shall invest and manage trust assets as a prudent investor would by considering the purposes, terms, distribution requirements, and other circumstances of the trust."*** The purposes of the trust are noted at Article Two, Section 5, Pages 6-7 of the trust document:

> In general, this Trust is therefore intended to supplement, and not supplant, the public benefit that would be available to the beneficiary if this trust did not exist. Currently, the beneficiary has basic living needs such as special programs and equipment that public beneficiary may not receive. It is vitally important that the Beneficiary receive these services to maintain a level of human dignity and humane care… [The trust is to be a] source of payment for either emergencies of supplemental support for the beneficiary's needs.

During our interview with the trustee on September 17, she reported that she understood from this term that the trust assets should be managed with a conservative mandate, seeking capital preservation over capital appreciation.

Duty to Establish Risk and Return Expectations - §16047(b): The code directs that the investment strategy adopted or approved by a trustee shall establish ***"...risk and return objectives reasonably suited to the trust."*** Given the trustee's reasonable interpretation of the trust purposes and the advice of the investment delegate, Archibald Capital, the trustee established a conservative investment mandate for the trust with a long-term expected return of 4%-6% and a commensurate risk expectation of 7.0% standard deviation.

Conservative Return Objective: Though Mr. Johnson may disagree with the trustee's decision to establish a conservative risk and return objective, he has not suggested that the trustee's discretionary decision was made in bad faith or imprudently. As the court stated in Bixby, "The exercise by the trustee or other designated person, if in good faith and according to his best judgment, shall be conclusive, irrespective of whether it may be in accordance with the determination which the court having jurisdiction would have made." (Estate of Bixby (1961) 55 Cal. 2d 819)

Duty to Diversify - §16048: The code directs that ***"...the trustee has a duty to diversify the investments of the trusteeship unless, under the circumstances, it is prudent not to do so."*** Our independent review of the portfolio managed by Archibald Capital, allocated with a conservative risk and return mandate, was reasonably diversified within (1) the number of securities held in the portfolio, (2) the market sectors represented by those securities, and (3) the asset classes represented by those securities. To be sure, reasonable minds can differ as to the "best" allocation that could/should be adopted to accomplish a conservative risk and return mandate during this measuring period. But the standard that the trustee's actions and this portfolio should be compared against is not the "best" but "reasonable" standards.

Diversification Using Municipal Bonds: Though Mr. Johnson may disagree with the investment advisor's decision to allocate a portion of the trust corpus to municipal and government bonds[4], it cannot be said that the trustee's decision to approve this recommended allocation was made in bad faith or imprudently. There are several reasons why Archibald Capital allocated a portion of the trust capital into bonds issued by municipalities and government agencies. Among these reasons are (1) increased safety of the counterparty over corporate bonds, (2) a clear preference in the probate code and trust document for government securities[5], (3) the contracting "credit spread" between taxable and government agency bonds which occurred in 2014 resulting in similar yields between corporate bonds and tax-free munis and (4) the pursuit of broader diversification of the fixed income asset class within the portfolio.

Duty to Incur Only Reasonable Expenses - §16050: The code directs that a ***"trustee may only incur costs that are appropriate and reasonable in relation to the assets, overall investment strategy, purposes, and other circumstances of the trust."*** The fees charged by Archibald Capital to the trust were 1.0% of the market value of the trust. The typical fee charged for trust of similar size and complexity is 1.02% according to the annual study conducted by AdvisoryHQ[6]. In our view, the fees charged by Archibald Capital for the management of these trust assets are fair and consistent with industry norms.

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[4] See "Report of Guardian Ad Litem Re Second and Current Account and Report of Trustee, and the Multiple Related Petitions" Page 11

[5] Trust Document Page 20 Section 4, and Probate Code §2574

[6]https://www.advisoryhq.com/articles/financial-advisor-fees-wealth-managers-planners-and-fee-only-advisors/#Percentage-AUM

<u>Duty to Prudently Select an Investment Delegate - §16052(a)(1)</u>: The code directs, ***"The trustee shall exercise prudence in… Selecting an agent."*** The trustee offered the following explanation for why she originally selected Archibald Capital as the investment delegate (advisor):

1) The advisor was highly recommended by several well-respected fiduciaries who are colleagues of the trustee.
2) The advisor reported to be familiar with the Prudent Investor Act and the particular rules and requirements associated with trusts that were overseen by the court.
3) The advisor is large, having over $750,000,000 of assets under management.
4) The advisor is registered with the SEC as a Registered Investment Adviser which requires that the advisor act only in the trust's best interest and that all recommendations and actions be held to the fiduciary standard.
5) The advisor had been in business for over 20 years (since 1996) suggesting long-standing success in delivering quality service to their clients.
6) The advisor's marketing material suggests that their team would use "…proprietary, rules-based risk models that are designed to systematically mitigate risk and identify opportunity… [resulting in] smooth portfolio returns by adjusting to market trends over long, intermediate and short-term time frames."[7]

<u>Duty to Prudently Delegate - §16052(a)(ii)</u>: The code directs, ***"The trustee shall exercise prudence in…establishing the scope and terms of the delegation."*** The trustee clearly delegated her investment expectation to the Investment Advisors as evidenced by the Investment Policy Statement and Client Risk Profile signed in early 2015 which established a "conservative" investment mandate with a performance objective of 4%-6% over a typical business cycle.[8]

<u>Duty to Independently Monitor the Agent's Activities - §16052(a)(iii)</u>: The code directs, ***"The trustee shall exercise prudence by… periodically reviewing the agent's overall performance and compliance with the terms of the delegation."*** To fulfill this duty to monitor, the trustee adopted several governance procedures. On a <u>monthly basis</u> the trustee reviewed the custodial statements that were independently produce by TD Ameritrade. The trustee specifically reviewed the (1) monthly income produced by the portfolio, (2) change in value—both positive and negative, month-to-month and

[7] http://archibald-capital.com/why-archibald/
[8] http://www.nber.org/cycles.html

year-to-date—in the portfolio and (3) transaction summary for any fees, charges or other expenses debited against the portfolio. On a quarterly basis the trustee had a phone call with the Archibald Capital team to discuss the anticipated upcoming distributions from the trust and the advisor's perspective of changes to the allocation given the prevailing market conditions. Finally, on an annual basis the trustee met with the advisor face to face to reaffirm the investment objective[9], review the prevailing economic and market conditions[10], review the portfolio's total performance[11], review the portfolio allocation[12], review the fee charged by the advisor during the year[13], and reaffirm the delegation of investment duties.[14]

"Monday Quarterback": The code directs, ***"Compliance with the prudent investor rule is determined in light of the facts and circumstances existing at the time of a trustee's decision or action and not by hindsight."*** [15] An accurate assessment of the trustee's decisions must take into consideration the market conditions at the time those decisions were made rather than using the benefit of hindsight. At the time that Archibald Capital was engaged, the S&P 500 had rebounded strongly since the dark days of the Great Recession by climbing from 1,000 in January 2009 to 2000 in January 2015, for a cumulative return of over 100% during this six-year period. At that time many market watchers and advisors were warning that the period of good performance would soon end. Following are a few examples:

1) In January of 2015 Goldman Sachs reported their expectation that over the next five years [2015-2020] the returns from cash and high-quality bonds would be negligible and US equities would produce modest single digit returns. Goldman Sachs Investment Strategy Group (Page 25 Exhibit 35)[16].
2) In the J.P. Morgan 2015 Long Term Capital Markets Report, the advisor forecasted an average return of 6.5% for US Large Cap Stocks over the next 5 year [2015-2020] (Page 80)[17].

[9] Duty to Establish Risk and Return Objectives - §16047(b)
[10] Duty to Consider Market Conditions - §16047(c)
[11] Duty to Consider Total Return - §16047(c)(5)
[12] Duty to Diversify - §16048
[13] Duty to Pay Reasonable Fees - §16050
[14] Duty to Prudently Delegate - §16052(a)(2)
[15] Contemporaneous Judgment - §16051
[16]https://www.goldmansachs.com/what-we-do/investment-management/private-wealth-management/intellectual-capital/isg-outlook-2015.pdf
[17]https://am.jpmorgan.com/blobcontent/1413613727995/83456/LTCMA_Assumptions_White_Paper_2015_US.pdf

3) The 2015 BofA Merrill Lynch Global Market Report[18] forecasted that the bull market would slow to a jog in 2015. They believed that the era of excess returns and low volatility was in the past. The expected gains from stocks in the year ahead implied a price return of approximately 6 percent, in line with an anticipated modest deceleration in earnings growth.

4) The Archibald Capital team shared the view that headwinds were expect for the stock market and that it would be prudent to slowly enter the market using a long and deliberate dollar-cost-average strategy. Archibald Capital cannot be faulted for this widely held point of view. The trustee cannot be faulted for relying of the advice of a qualified expert who shared a perspective widely held in the industry.

Conclusion: We find no evidence that the trustee failed to perform her duties of care to prudently delegate or monitor the activities of Archibald Capital during the period between April 2015 and June 2017 as Mr. Johnson has suggested. Mr. Johnson's opinion that the return from the portfolio was "…paltry considering overall stock market conditions"[19] does not appear to consider that a growth-oriented portfolio allocation, made up primarily/exclusively of the "stock market", would not be appropriate for this trust.

In our professional opinion the trustee was reasonable in her decision to establish a conservative investment mandate. Her reasons for selecting this investment advisor were reasonably based. Her governance process for measuring the advisor's subsequent activities were reasonable, prudent and consistent with her duties of care.

We expect that the court will deny any petition for a surcharge noting that a trustee "…is not liable to the beneficiaries or to the trust for the decisions or actions of the agent to whom the function was delegated" (CPC §16052(c)).

[18] https://newsroom.bankofamerica.com/press-releases/economic-and-industry-outlooks/2015-market-outlook-bofa-merrill-lynch-global

[19] "Report of Guardian Ad Litem Re Second and Current Account and Report of Trustee, and the Multiple Related Petitions" dated May 18, 2018

Exhibit A

Though beyond the scope of this engagement and in no way informative as to the trustee's fulfillment of her duties of care, Anodos has conducted a benchmarking study as part of this evaluation.

A Word about Benchmarks: Before a benchmarking analysis begins, one must realize that there is no perfect benchmark that can be constructed to precisely measure the successes or failures in the manager's activities. As such, a *series* of benchmarks should be developed which, each in their own way, help the analyst judge whether the defined investment objectives are being accomplished.

Sufficiency of Data: In the same way it would be a mistake to too quickly judge the caliber of a professional athlete from their performance in one game, the trustee should appreciate that it would be a mistake to judge their investment advisor's performance from too brief an investment period. To be sure, informed observations can be made throughout the measurement process, but meaningful conclusions can only be reached with a statistically significant sample size which could require a minimum of five years' (60 monthly return observations) worth of performance history.[20], [21] Our opinion is that given the short sample period in this case, meaningful conclusions cannot be reached from the study provided above.

Apples to Apples: We suggest that the comparison of the risk and return of a trust with a conservative investment mandate to the "stock market" is inconsistent with benchmarking best practices. A more appropriate analysis would be to compare the portfolio's performance to series of benchmarks with similarly conservative risk and return profiles. This "apples to apples" comparison would better determine if the return produced by the investment delegate was in the right "zip code" for similarly managed portfolio.

Portfolio Annualized Return (net of fee)*	**1.49%**[22]
Targeted Return (long-term)	5.00%

[20] https://investors-corner.bnpparibas-am.com/investment-themes/sample-size-matters/

[21] https://www.investopedia.com/terms/s/sample-size-neglect.asp

[22] The portfolio's return of 1.51% below the Morningstar Conservative Target Risk Index is consistent with a normal outcome, noting the advisor's fee and the underlying product level (mutual funds) fees are not imputed to the benchmark.

Morningstar Conservative Target Risk Index	3.00%
Peer Group Benchmark (MS Category Avg-15%-30% Equity)	2.40%

*Measuring Period: April 1, 2015 - June 30, 2017

Benchmarking Shortcomings: Any manager's individual performance above or below a benchmark will be explained by (1) the lack of fees imputed to the benchmark, (2) the assets the manager holds that are not included in the benchmark, (3) the difference in weightings of the managers' selected asset classes from those of the benchmark, (4) the perpetual cost-free rebalancing of the benchmark and (5) the drag on performance that any cash in the account will cause.

Exhibit B

About Anodos: Anodos is a Chief Compliance Officer for trustees of all types: individual trustees, ERISA trustees, and foundation/endowment board members. We develop and maintain for our clients a fiduciary governance process that fulfills their oversight responsibilities. Because we do not sell insurance, manage money, or receive referral fees from any sources, our governance work is truly unconflicted.

About Josh Yager: Josh is a recognized content expert on the issues of fiduciary duties relating to the management and oversight of trust assets. He lectures extensively on the policies and procedures for conducting investment manager audits to CPAs, attorneys, and professional fiduciaries throughout the country. Josh is Managing Partner at Anodos Advisors and a licensed attorney. Prior to founding Anodos in 2005, Josh worked for fifteen years as an investment advisor with Mercer Advisors.

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