

# REALASSETS

## ADVISER



## Institutional to Individual

Michael Forman and Franklin Square aim to create more alternatives for the common investor

### Is Water the New Oil?

And what are the investment opportunities for high-net-worth investors?

### Niche Real Assets

Investors who bet on fine art, classic cars and other objects of their obsession

### REIT Respect

The addition of the real estate sector to GICS should have far-reaching implications

By Mike Consol

# *Institutional* **TO** *Individual*

**Michael Forman** and Franklin Square aim to create more alternatives for the common investor

**F**ind an underserved market, and you find an opportunity. That business adage might not have formed quite that way in the mind of Michael Forman, but it applies nicely to his thinking during 2006, when he had an inspiration to deliver institutional-style investment options to individual investors — private debt and equity investments, as well as other alternatives. Add to that the vast U.S. middle market suffering from a post-financial-crisis credit crunch, and Forman had the makings of a two-headed strategy for a new investment management firm aimed squarely at high-net-worth individuals and the financial advisers that serve them.

Forman was a business attorney in Philadelphia at the time and was cogitating on the notion for about a year before pulling the trigger on the formation of Franklin Square Capital Partners in 2007.

“The more time I spent with the idea, the more I liked the concept and our mission,” he recalls.





*“To put it in perspective, endowments often allocate 50 percent of their portfolios to real assets, while the typical individual investor allocates only 4 percent.”*

He also recalls how his daily commute to work took him past a Center City park in Philadelphia called Franklin Square, close to the Benjamin Franklin Bridge, both obviously named after the esteemed founding father and signatory to the U.S. Constitution. Forman calls him “a great Philadelphian and a great American.” He liked the name, and what it represented, and co-opted it for his new firm.

Forman says the mission was to bring best-in-class managers and institutional asset classes to individual investors and small institutions. In other words, to give retail investors access to the same alternative investment options long available to institutional investors such as pension funds, foundations, endowments and sovereign wealth funds. To put it in perspective, Forman notes endowments often allocate 50 percent or more of their portfolios to real assets and alternatives, while the typical individual investor portfolio allocates only about 4 percent. In a persistently low interest-rate environment, where global stocks have been volatile and trillions of dollars of bonds are generating negative yields, he says investors have to think differently to generate meaningful returns to adequately save for retirement.

The key to achieving Forman’s vision was the Investment Company Act, which was adopted in 1940 and updated in 1980. Called “the ‘40 Act” for short, the legislation was intended to encourage investment in middle-market companies in the United States. It allowed the formation of busi-

ness development companies (BDCs), which were required by law to invest 70 percent of the funds they raised from investors into companies with less than \$250 million in market value. *(See related article on page 35.)*

Forman realized the BDC construct could be used to allow individual investors to participate in the same vehicles as institutional investors, specifically in funds that lent to middle-market companies. While other publicly traded BDCs existed, Forman says he introduced the first non-traded BDC, FS Investment Corporation (FSIC), in 2009.

With FSIC available via independent broker/dealers and RIAs, retail investors could participate for as little as \$5,000, with the prospect of earning the same kind of returns as institutional investors.

“It has been a game changer for advisers and investors,” says Forman.

Fast forward to today: Franklin Square has created six closed-end funds in total. The flagship fund, FSIC, was listed on the New York Stock Exchange in 2014 and has about \$4 billion in assets under management. The firm followed with three more offerings in the FSIC fund family, as well as a credit-focused energy and power fund and a global credit opportunities fund.

Given the current yield-starved environment, Forman sees the BDC as an alternative instrument for generating the kind of strong income that stocks, bonds and traditional fixed-income channels have

# GETTING PERSONAL

## *Michael Forman*

**If you could go back in time, what would you tell a 25-year-old Michael Forman?**  
Be patient

**What is the most influential book you have read?**  
*Good to Great* by Jim Collins

**What is the biggest lesson you've learned?**  
The importance of building trust with colleagues, peers and clients

**What is your favorite quotation?**  
"Luck is the intersection of preparation and opportunity" (Vince Lombardi)

**What is your idea of perfect happiness?**  
Dinner at home with my wife and three daughters

**What is your most pronounced characteristic?**  
Discipline

**How do you want to be remembered?**  
As someone who always gave more than he took



not been able to deliver consistently. Franklin Square–managed BDCs have a cumulative \$15 billion in assets under management, making the firm the country’s largest manager of BDCs.

Franklin Square has grown from a few employees in 2007 to 315 today. In percentage terms, annual headcount growth has averaged 30 percent to 40 percent during the past few years. As the firm operates from a larger base of revenue and AUM, Forman expects the growth rate to moderate to something more along the lines of 10 percent to 20 percent per annum.

With AUM growth comes the need for more of the “best-in-class” talent that Forman touts, and that means the national search is on for skilled investment managers. Bringing new talent aboard has become less onerous, says Forman, as the firm’s reputation has expanded.

In addition to the recruitment of new talent, future growth is expected to be fueled by market volatility. While volatility is generally the bane of wealth advisers and investors, Forman recently told Bloomberg he sees volatility creating opportunity for Franklin Square. Asked to elaborate, he told Real Assets Adviser his firm continually raises fresh investor capital, which gives Franklin Square the latitude to deploy assets through all market cycles, meaning in times of volatility, the firm will not be forced to sell to meet redemptions. Rather, it will be in a position to buy — at favorable pricing — what others are forced to sell.

Furthermore, Forman considers fund structure to be critically important. Closed-end funds do not have to manage to the same investor redemption pressures that open-end funds do. Bouts of heightened volatility exacerbate that pressure on open-end funds, as is currently being seen as a result of the Brexit referendum, with several open-end U.K. real estate funds freezing investor redemptions because of liquidity issues.

“This can help boost returns for our investors,” says Forman.

## GOING FOR THE MID-SECTION

So far, the firm has concentrated its efforts on two asset classes: One is private credit; the second is middle-market private equity.

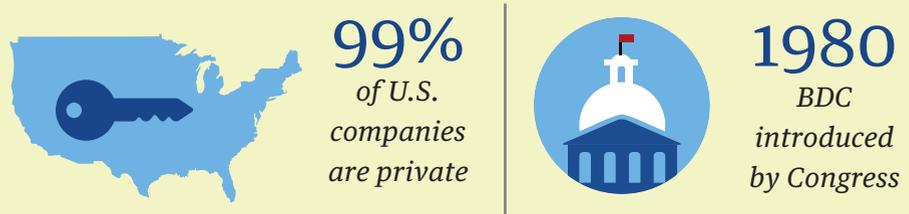
## What is a Business Development Company?

Business development companies are closed-end funds that invest in private U.S. businesses. BDCs act as a lender to private companies, lending money similar to a bank. They are generally required to invest at least 70% of their assets in private U.S. companies or public U.S. companies with market values of less than \$250 million.



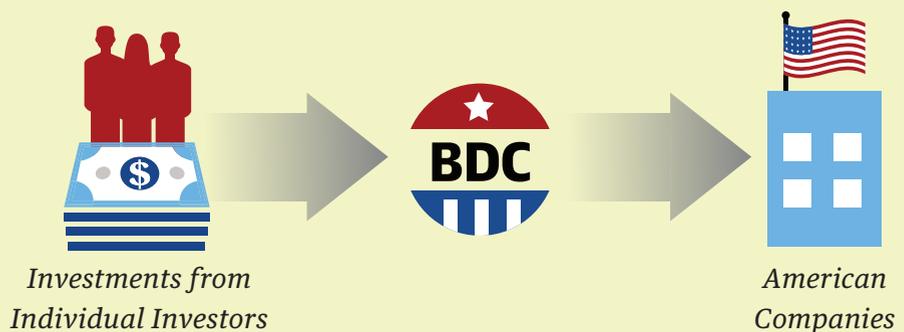
### Why were BDCs created?

Congress created the BDC in 1980 through an amendment to the Investment Company Act of 1940 to help private U.S. companies raise money from individuals. BDCs have become an increasingly meaningful source of capital to help finance and grow private American businesses — and in the process have potentially created jobs and helped fuel the growth of the American economy.



### Why might an investor consider investing in a BDC?

BDCs provide individuals with access to private debt and equity investments, which have historically been available only to large institutions, such as pension funds and university endowments. Some BDCs focus primarily on providing loans to private companies. Because BDCs must distribute at least 90% of their earnings to investors to maintain qualification as a regulated investment company for tax purposes, BDCs may provide investors with a high level of current income. Plus, a BDC’s investments may be less correlated to traditional investments, like stocks and bonds. This may help to diversify an investor’s portfolio and smooth out volatility.



### Risks of investing in BDCs

An investment in a BDC involves a high degree of risk and may be considered speculative. Investors should consult with their financial adviser and carefully consider all of the information and risk factors contained in a BDC’s publicly filed prospectus before deciding to invest.

# Franklin Square Capital Partners by the Numbers

## Headquarters

Philadelphia

## Year founded

2007

## Personnel

315

## Funds

Six

## Assets under management

\$17 billion

## Portfolio companies

125

## Dollars invested

\$16 billion

Forman sees private credit as an asset class that can generate significant yield and performs well over long periods of time. And he believes middle-market private equity offers better risk-adjusted returns than larger private equity deals.

The primary focus has been on private middle-market credit, which is most efficiently accessed via the BDC structure, in Forman's estimation. Why? Because BDCs are highly regulated and transparent, providing investor protections that some other structures do not.

The middle market, more than 200,000 companies strong, is the growth engine of the U.S. economy, representing nearly one-third of private sector GDP. If it was its own entity, it would be the world's fifth-largest economy, placing it just ahead of the United Kingdom. In fact, 96 percent of all U.S. companies are privately held, while only 4 percent are publicly traded on exchanges. Yet, Forman says, many successful middle-

market companies are starved for capital because banks have significantly scaled back lending activities under stringent and perpetually shifting regulations. That gaping hole in the market represents a great opportunity for sophisticated non-bank lenders. Consider that about \$575 billion dollars in middle-market debt is coming due in the next five years, and banks have largely abdicated that market segment.

Along comes Franklin Square which has lent just shy of \$16 billion to 125 companies headquartered in 29 states. Both middle-market revenues and employee headcount growth are expected to outpace the overall economy in 2016, so the need for capital will continue.

Another reason Forman is enthused about middle-market companies is, on average, they derive nearly 90 percent of their revenues domestically, keeping them mostly clear of the stresses caused by slowing growth in China, the falling fortunes of emerging

growth markets such as Brazil and Russia, and market panic over Brexit.

Forman estimates the firm will invest at least \$2 billion more in the market segment during the next 12 months, though he acknowledges that will depend on market conditions and the pace at which Franklin Square raises new investment capital and collects returned capital from loan paydowns from its portfolio companies.

The fresh investment dollars are expected to come from a client base Forman describes as the "mass affluent" — high-net-worth individuals, families and small institutions who might invest as little as \$20,000 or as much as \$10 million (though, as previously mentioned, the minimum participation in some funds can be as low as \$5,000). Reaching that group requires intermediaries in the form of wealth advisers, who direct their affluent clients in Franklin Square's direction. That is something the firm has worked hard to facilitate. Currently, Frank-



“It has been a practice of ours from day one to infuse our products and processes with transparency,” he says. “That has always been the cornerstone of what we do.”

An example cited by Forman is the level of disclosure regarding marking its financial investments to market. All BDC investors see the holdings and the value of every investment in their portfolios as a matter of regulatory course, much of that driven by the Investment Company Act of 1940. The '40 Act requires portfolios be marked to market annually. Franklin Square takes that a few steps further, marking to market all assets in its portfolios every quarter.

Specifically, a fund's net asset value, or NAV, is its total assets under management, minus its liabilities detailed on a per-share basis. The fund's NAV reflects an estimation of its value. NAV-based pricing means a fund's share price adjusts as its NAV moves up or down. Forman says NAV-based pricing is important for investors because it helps ensure all investors are treated equally and the price investors pay reflects the value of the fund, regardless of when they invest. This is particularly important for alternative investment funds, where the ability for existing investors to sell their shares might be limited.

The '40 Act also helps ensure the transparency of BDCs for investors by requiring their managers to maintain an independent board of directors and an independent custodian.

## THE ROAD AHEAD

Franklin Square now has its sights set on providing investors with a broader array of alternative asset classes, such as real estate, infrastructure and natural resources, in keeping with its philosophy that diversity is the bedrock of better investment portfolios.

Says Forman: “It's a mission that drives us each and every day.” ■

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lin Square has relationships with more than 37,000 advisers and 250,000 clients. Sales, distribution and support personnel account for half of Franklin Square's 315 staff members, with the balance focused on fund management, investment management and other support functions.

## BACK TO CLASS

While those numbers sound impressive, an enormous portion of the adviser market still deals strictly in two-dimensional portfolios constructed only of stocks and bonds (and perhaps some cash). Alternatives and real assets are foreign languages to most advisers, which is why Franklin Square expends great energy on “education.”

“That's really the centerpiece of Franklin Square,” says Forman. “We invest in educating advisers about the benefits of portfolio diversification with alternatives. We just conducted our 97th consecutive monthly education forum with advisers.”

The importance Forman places on outreach and education is underscored by the fact he personally has been a part of all 97 of those monthly forums, which are held around the country. The firm also hosts frequent webinars, meetings and phone conferences open to advisers, as well as publishing white papers, market commentaries and the like.

“We've taken the long view and really worked hard to build relationships of trust with our advisers — overcommunicating, not overpromising, building long-term relationships with our clients,” says Forman. “We really focus on building a sustainable culture of high performance and engagement.”

## SEE-THROUGH INVESTMENTS

Another point of emphasis for Forman is transparency. Too many alternative investments fall short on transparency, he says, and that might be one of the factors keeping many wealth advisers at a distance.