FRMO Corp. Q1 2015 Conference Call

Tuesday, October 21, 2014

Operator

Good day and welcome to the FRMO Corp. 2015 First Quarter Conference Call. As a reminder, today's call is being recorded. At this time I would like to turn the conference over to Thérèse Byars. Please go ahead.

Thérèse Byars – Corporate Secretary of FRMO Corp.

Good afternoon, everyone. My name is Thérèse Byars, and I'm the Corporate Secretary of FRMO Corp. We appreciate all of you joining us for today's call.

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Today's discussion will be led by Murray Stahl, Chairman and Chief Executive Officer of FRMO Corp. He will review key points related to the first quarter earnings. Once he has completed his remarks, we will move to questions. A summary transcript of this call will be posted on the FRMO website in the coming weeks. With that, I'll turn the discussion over to Murray.

Murray Stahl – Chairman & Chief Executive Officer

Thanks, Thérèse, and thanks all for joining us today. Ordinarily, Steve Bregman would be with me, but he had to attend to some family health issues which, as important as we think FRMO is, family is more important, and that's where we need him to be. So, you'll have the pleasure of interrogating me today if you choose to.

I'm going to review the income statement and balance sheet in two ways, not just to touch on the highlights, but to orient you to some minor format changes due to certain investments we made last year. Then I'm going to talk a little about Horizon Kinetics. Next I'll talk about more strategic issues concerning what's happened in the world of indexation because it broadly affects what we are thinking about doing. Then I will address some questions.

To begin with, let's turn to the statement of income, otherwise known as the revenue page. To orient you, understand that when you look at the revenue segment, for analytical purposes, you can divide it into a couple of groups. You'll see what's called consultancy and advisory fees which, for all intents and purposes, primarily consist of our Horizon Kinetics ("Horizon Kinetics" or "Horizon") revenue share. That's an important number for us because, as you'll recall, that's the money we get from the top line of Horizon.

The dividends and interest income is an important line, but less important for the reason that much of our interest income comes from bond funds. I'll have more to say about bond funds later, but we are going to have to make changes in that area. There are some realized gains from investments we have on our own balance sheet, but we don't trade a lot; therefore, we don't see a lot of realized gains.

There is income that comes from the investment partnerships in limited liability companies—the private funds. The value fluctuates from year to year, but that is because those are gains that we realize. There is a new line item, which is the income from FRMO's investment in the Bermuda Stock Exchange. Because we control so much of it, our accountants have advised us that we, in effect, can consolidate the Bermuda Stock Exchange, and we can increase the balance sheet carrying value, because it makes money.

There are also the usual expenses, which I regard as negligible. After subtracting the various expenses from the various revenue categories, we have our income from operations. We accrue and pay the appropriate tax rate. There's another line called comprehensive income and that is the change in market value of our balance sheet investments, such as they are, which are the securities we own directly, as well as the partnerships we invest in. Net of everything, we made $2.8 million after taxes.

Now, as we turn to the balance sheet, understand that when we accrue as we did the $1.2-odd million for tax expenses related to comprehensive income and/or loss, we actually didn't pay the tax at this point. You'll notice on our liabilities a pretty large deferred tax liability of $9.971 million—almost $10 million. Add a non-current tax liability on top of that of $4.2-odd million, to get about $14 million in deferred taxes on monies that we theoretically owe to the government, but which we don't have to pay until the gain is realized. Someone asked me if I ever thought I'd be in a situation where I owed $14 million to the government. I actually thought I would, and it turns out that I do, or *we* do collectively, because we are all shareholders.

On the balance sheet, I'm going to skip some of the current assets and come back to them, because I want to call your attention to some changes here. You'll note that the Bermuda Stock Exchange is carried as an investment at cost, and that cost is going to change—hopefully go up—as we accrue profits. Then there is the investment in Horizon Kinetics LLC, FRMO's own investment held at cost, which is different from the revenue share. As we, in the context of Horizon Kinetics, reinvest some of our profits, you'll see that treated the same way.

Finally, you'll see the value we put on FRMO's participation in the Horizon Kinetics revenue stream, which is a little over $10 million, and that's going to stay constant. When you look at our revenue in relation to the cost basis, you can see how important that investment is for us. On prior occasions, I expounded at length on that, so I won't repeat myself here.

In the more traditional current assets, you'll see the investment in South LaSalle Partners, which is really an investment in the Minneapolis Grain Exchange. We broke that investment out for you because, first of all, at $5.7 million, it's an important investment for us. Secondly, it's a strategic investment for us. More about that in due course.

It’s treated as a current asset because, theoretically, we could sell the seats but, as a practical matter, we have no plans to sell them. Therefore, although that investment is carried as a current asset, intellectually it’s more like a long-term investment.

If you go down some levels to the bottom of the balance sheet, you’ll see a couple of interesting items. You’ll see shareholders’ equity of $98.381 million—nearly $98.4 million. It is approaching the $100 million mark. Some people would say we’ll be a real company at that point. In terms of total assets—an important line for us—it’s over $115 million. That’s a big balance sheet.

When you look at our cash, our investments that we could liquidate and, though you can’t see them, if you could look at the various margin lines on which we could rely if we wanted to, you would see that there is a lot of liquidity in this company. Theoretically, we could do something with it. That doesn’t mean we’re going to do something with it. In terms of the scale of operations and the scale of assets, I would dare say, they are of a somewhat different character than they were historically. I would also say that they are much more substantial, and we now have the power to do a lot more than we were able to in the past.

Let’s turn to our most interesting investment at the moment, which is Horizon Kinetics. At least in terms of the revenue share, it’s very important. At fiscal year-end August 31, Horizon Kinetics had approximately $9.8 billion of assets under management. That figure stayed, month-by-month, relatively constant at around the $10 billion mark. It fluctuated slightly with asset value and with inflows and outflows in the various funds. The assets under management are organized as follows: 7% are in alternatives—what some would call hedge funds; 8% are from various kinds of sub-advisory contracts; 22% are from institutions—loosely defined in my opinion; 22% are in mutual funds. Financial intermediaries, which means dual contract or WRAP programs for us, are 18%, and 23% and are from high net-worth direct investors.

Now for some highlights within that group. Strategically important, though very small for us, is the joint venture we have with Virtus Investment Partners, the Wealth Masters Mutual Fund (VWMAX). I’ll talk about it factually now and about its strategic importance later. It has roughly $131 million in assets under management. It’s not an ETF; it’s a mutual fund based on the Horizon Kinetics ISE Wealth Index (RCH). However, if you make believe, for analytical purposes, that it is an ETF, and given that there are about 1,700 ETFs in the U.S., I think, if you ranked all the ETFs in the U.S., the Wealth Masters Fund would be somewhere in the middle, maybe even above median in terms of assets under management.

That’s important in and of itself, without considering the profitability, because it’s very difficult to start an index and get traction. Few are able to do it. Alternatively stated, of all the standard indexes, including the S&P 500 indexes, the various bond indexes, the emerging markets indexes, and others, you might say that they’re all taken, and I think you would be right to say that. Therefore, if you're going to be in this business, you really need to invent something, and that’s what we did. It’s not easy, even if you license someone else's index, to get assets of scale, but we have managed to do that. I believe that at fiscal year-end of 2013, which was about 14 months ago, we had approximately $7 million in the fund. Thus, it went from $7 million-plus to $131 million-plus. We’re not congratulating ourselves, but it’s not an unsatisfactory result.

Looking at it another way, I'll use VWMAX to introduce some bigger and broader things going on in the markets that are important for us, to which I will relate various investments we have made. Regarding the most recent market correction, from my perspective, the most salient feature of that correction is that if you look closely you will see that, allowing for some rounding error, the various indexes, especially those we made reference to, such as the S&P 500, the Russell 2000 small cap index, the emerging markets indexes, the EAFE index (Europe, Australia and the Far East), and some subsets of those geographically, *all went down at the same rate*.

That fact might be shocking to some, but it wasn't shocking to me—it didn't surprise me at all. First, if the indexes are to be dominated by companies with the greatest float (that is, the largest companies, which are primarily the global multinational companies that do business with each other in each other's countries), do they really provide exposure to the economies of the individual nations? Let's take Coca-Cola as an example. Obviously it's in the S&P 500, and I did not choose Coca-Cola randomly. I chose it deliberately, because it's the most quintessentially American company you can find, yet two-thirds of its revenue comes from outside the United States. If you make an investment in Coca-Cola, are you really making an investment in the United States? Many other companies in the S&P 500 share that same characteristic.

Looking at a company outside of the United States, I often make reference to Nestlé. It's a Swiss company that does very little of its business in Switzerland. Surely no one would argue that Nestlé is a Swiss company in the sense that one would make an investment in it to express an economic view on the GDP trend of Switzerland. Nestlé is a global company; much of its business is done in the United States and other countries. As a result, when there is a slowdown in the global economy, the global indexes, composed as they are of globally oriented companies, go down together. That's a big problem if you are an indexer.

To give you further orientation, the total assets under management in ETFs in the United States amount to roughly $1.9 trillion. Of late, assuming the market doesn't fluctuate, that figure will grow by $8 billion a week. I ask you rhetorically, what's the point of putting more money in the primary indexes, or asset classes, as people call them, which include the U.S. large capitalization asset class, the U.S. small capitalization asset class, the small or large cap emerging markets asset class, to name but a few? If they are asset classes, they should behave differently, in the same sense that bonds as an asset class behave differently than stocks. We expect asset classes to behave differently, but the equity asset classes are not behaving differently at all.

What can one do about it? The only thing you really can do about it is to position yourselves as idiosyncratic investors. An example of that is the previously mentioned Horizon Kinetics ISE Wealth Index (RCH), on which the Wealth Masters Mutual Fund (VWMAX) is based. The Wealth Index is composed of what we refer to broadly speaking as primarily owner/operator companies, which we define generally as companies in which a wealthy individual made a big investment. In other words, they put a lot of their eggs in one basket, and they watch that basket very carefully. It has a different volatility characteristic than the general market, sometimes for the better and sometimes for the worse.

For those interested in achieving diversification, the only thing you really can do is to buy something that’s idiosyncratic, and I believe the Wealth Masters Fund is an example of such an investment. I could also tell you that in short order we hope to launch an international version of the Wealth Index. I can’t guarantee that we will do that, but that is our intention.

Turning to Horizon Kinetics, there is another way of looking at that investment. There is a statistic called Active Share that measures the level of active management. It ranks managers by how much their portfolio stock holdings differ from the index used as a benchmark. Active Share basically ranks managers on a scale of 1% to 100%. A manager with an Active Share ranking of 1% has a portfolio that is more or less like its benchmark, such as the S&P 500. A manager ranking of 100% would have no similarity whatsoever to the S&P 500. I don’t recall exactly what the Horizon Kinetics rank is, but I do recall that it’s so high that it’s higher just about anybody’s, and that bodes very well. If you are an aficionado and read the scholarly literature on this subject, you would see that, prior to the most recent correction, a term used in the formulation of indexes is “smart beta.” An index is basically beta, meaning it provides exposure to the variability of a certain subset of the marketplace, or of the broader marketplace if you use an index such as the S&P 500. Smart beta refers to the idea of excluding certain elements of the market because they entail certain characteristics that make them perform worse than the market itself. In theory, if you remove these elements from the index, you have what's called smart beta.

In the last couple of weeks, they seem to have dropped that term; at least, I don’t see it used all that much lately. In its place I’ve been seeing another term called “alternative beta.” What's the difference between smart beta and alternative beta? Alternative beta refers either to active managers and/or to indexes that have very little resemblance to the overall indexes in terms of their composition. The idea is that if you combine a manager with a high Active Share rating with a conventional index, you could argue perhaps that you have some measure of diversification. I think that, in short order, that’s going to be an interesting development. It should, I hope, affect Horizon Kinetics positively.

There is another way of looking at this situation, which I referred to in the last conference call. I’ll go into a little more detail now. The average security clearly is fluctuating with the marketplace and is not providing the diversification that it did historically. As a consequence, it’s the security itself that’s problematic, because it has what’s called in the academic literature “non-observable parameters.”

What does that mean? It means that I can look at the largest stocks and find nothing intrinsic about the securities themselves that indicates what their behavioral characteristics will be. The earnings might go up, in which case, hopefully, the stock goes up. Or the earnings could go up and interest rates go up, but the stock might go down anyway. Or interest rates could go down, and the earnings could go down, or any of those combinations.

I believe that there are ways of disaggregating some of the characteristics of the companies and putting them in publicly traded vehicles. In other words, doing something that no one has ever done before, which is to create subsets of securities that actually have certain structural properties that one could point to that, while not guaranteeing success, might assure you more or less that the behavioral characteristics of those given subsets will be different and distinct from those of the various securities in question.

Having said that much, you can now understand why we've been so interested in making investments in exchanges. If you go back to the 17th century, when the London Stock Exchange started, and look at how securities came to be listed, you'll see that they all came from what's called in the vernacular "the sell side." Corporations decided that it was to their advantage to issue securities. Sometimes more securities were issued, sometimes fewer, and there were even periods of time when no securities were issued.

As an investment manager today, depending on what your objectives are, what you'd like to accomplish is to draw from the various publically traded securities to blend them in whatever combination you like and, hopefully, create a portfolio that will embrace the characteristics you're trying to give to your client base. The "buy-side," that is the investment management side, never really got involved in structuring the investments or in creating the securities. It never happened for historical reasons.

The buy-side is what you might think of as an irony of history. It's referred to as the active managers, but it's not as active as you might think. It's passive in the sense that it's just choosing between the securities that exist. It's not active in the sense of thinking through the risk and reward characteristics that clients would like to have and seeing to it that securities exist that have those characteristics. I believe that with modern technology it's possible to do that. It's one of the areas we are exploring at the moment. I can't go further than that; I can do no more than pique your curiosity.

We have a balance sheet that will enable us to do a lot of work in that regard and much more. We are cash flow positive. Our investments, by and large, are successful. As you can see, we have a lot of liquidity in the balance sheet, and we have some borrowing power if we choose to use it. We have no current plans to use it, but we do have the borrowing power.

That's the best way I can sum up our situation at the moment. We are, as I would say, graduating to a higher level. Hopefully, crossing the $100 million threshold in total assets in the not too distant future could put us in a different class and give us a little more flexibility to do the things that we'd like to do. I think we're in a pretty good position. Naturally, we'd always like to be in a better position, and we're doing everything we can to accomplish that. Life is not bad at the moment, and we'll do everything we can to see to it that it gets better.

At this time, I'll take questions, but first I'll address a question that was emailed in advance of this call. It is not 100% an FRMO question, but I'll read it anyway and will respond to it.

Questioner 1:

Would you talk about why you have been selling down Rouse (RSE)—what has changed in the story?

Murray Stahl – Chairman & Chief Executive Officer

This question really pertains to Horizon Kinetics, but I'll address it now anyway. Nothing has changed in the story. We did sell it down, but the only reason is because we needed money to do other things. Rouse, of course, is a spin-off and, in the most recent several months, as you will have observed, there are a lot of scheduled spin-offs, as well as many that have already been consummated. Sometimes we like to buy a few. To do that, we need funds, and they have to come from somewhere. This time they came from Rouse, but that doesn't mean that there is anything wrong with Rouse.

Also, we own a security called Brookfield Asset Management and, because they control Rouse, we have exposure to it in that way. That's the only reason for choosing Rouse as a means of raising money, because we have exposure to it via another modality. We're not suggesting anything bad about Rouse.

Questioner 2:

With FRMO's stock price decently high, would you consider using the stock as currency?

Murray Stahl – Chairman & Chief Executive Officer

Looking at the balance sheet, you'll see that we have nearly $28 million of cash on the balance sheet, and that number is growing, so if we want to do something, we can first rely on that. There's another item to look at, which is the $56 million of other investments which are available for sale. Within that figure are a fair number of investments in closed end bond funds. In the shareholder letter I made reference to that.

Those closed end bond funds ended up being great investments for us, because we basically invested in bonds on a leveraged basis. You know how well bonds did in the last couple of years, and we received the interest income as well. However, at the current levels of interest rates—and everybody knows how low they are—we don't even get those rates, because we pay taxes on all the interest income, obviously. It's a low return asset for us. If we're thinking about capital allocation, the first order of business is that we have two big low-return buckets to work with long before we get to the stage of equity issuance. We have a lot we can do there.

In terms of the equity, I can't tell you anything about its value, because that's not permitted, but understand that all the investments we've made, apart from the cash and the bonds, are designed in the same way as the Horizon Kinetics revenue share is designed. The idea is to have a lot of operating leverage. If you take the exchanges, for example, they're just platforms. There is a more or less fixed cost of running them. We got involved in these exchanges because, at the moment, those are the smallest exchanges and we can invest in them fairly cheaply. If something good were to happen, and I'm not saying anything good is going to happen but, if did, there could be a lot more revenue flowing through that system without a lot more cost.

Were we to issue stock, in a certain sense we would not merely be issuing stock, but we would be selling a piece of all our investments. For example, if I want to invest $100, and my choices are to take a $100 out of cash, equities, or the bond portfolio, what would I do? Chances are I'd probably take it out of the bond portfolio, not the stock portfolio. The reason is because the bond portfolio doesn't pay a lot anymore, and it actually has price risk.

I can go a step further and say, theoretically, why not issue stock? If I had nothing but cash and bonds on the balance sheet I might say, "Oh, what a great idea." You could look at it and say there is shareholders' equity of $98 million, the market capitalization is higher than that, and I'm selling stock at an antidilutive price to book value ratio, and any stock I sell would add to book value, and how wonderful is that? But, the reality is that I would also be selling pieces of an interest in the Bermuda Stock Exchange and an investment interest in Horizon Kinetics LLC, and I would also be selling a participation in the Horizon Kinetics revenue share. I personally like those investments; consequently, you can see why, at the current time, I'm reluctant to use the security, which would be, effectively selling pieces of those instrumentalities.

We have a certain carrying value for accounting purposes, and you can see how much revenue we get from it. Reasonable minds may differ on what the value is—I discussed this in one of the shareholder letters—I think that if I sold the revenue share at the balance sheet carrying value, the shareholders would have to ask themselves if they are happy with me or upset with me. My guess is that they might be upset with me and I'd be upset with myself; therefore, why would I do that? With that said, I should offer the normal disclaimer that I might do anything at any time, for any reason. I'm not making any statement, implied or otherwise, about the value. I'm just providing you with an insight into the way I'm thinking about capital allocation.

By the way, one more choice is that we could borrow money. We haven't done it but, in theory, we could. Since the interest rate is very low, you could make an argument that if we could borrow money at a low interest rate for 30 years, and the interest expense is tax deductible, maybe we should do it. We live in the world of low interest rates, and there are many investments out there that trade where they trade because of interest rates. In other circumstances I might look at it very differently, but for now it's not our cup of tea. There are many different ways to get financing if we need it. Of course, all those considerations are moot in the sense that first you need a great idea, and that's the hardest part. I'm not sure that I have one at the moment, but I'm working on it.

Since there are no further questions, and we are getting close to 5 o'clock, we are going to conclude the meeting. Of course, we will reprise this in three months, at our next earnings call. In the interim, if you have any questions, you can e-mail them, and we'll be delighted to respond to you. Thanks for joining us and for being shareholders.

Operator

Thank you, everyone. That concludes today's conference. We thank you for your participation.

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