Operator

Good day, everyone, and welcome to the FRMO Corp. 2016 Second Quarter Conference Call. Today's call is being recorded. And at this time I'd like to turn the conference over to Ms. Thérèse Byars. Please go ahead.

Thérèse Byars – Corporate Secretary of FRMO Corp.

Thank you. 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., and Steven Bregman, President and Chief Financial Officer. They will review key points related to the 2016 second quarter earnings.

A summary transcript of this call will be posted on the FRMO website in the coming weeks. And now, I'll turn the discussion over to Steven Bregman.

Steven Bregman – President & Chief Financial Officer

Good afternoon. I'll review a few items that stand out on the balance sheet. You'll notice that cash and equivalents for the quarter ended November 30, 2015 are higher. That's a function, in part, of our raising more cash in investment portfolios, as we've been doing for quite a while, not just in FRMO Corp. You will notice some change in value of the investment in South LaSalle Partners, which is simply a function of a change in seat prices at Minneapolis Grain Exchange. You will notice that other investments available for sale are lower. That's predominantly a market value function—prices of securities.

There is a new investment you'll see that was made in OneChicago LLC, which we have mentioned in the past and which Murray will discuss later in the call. Briefly, OneChicago is an exchange specializing in single-stock futures. One of its attractive aspects for some participants in the market is that it costs maybe a half a percentage point or so to lend or be short a similar security, as opposed to an 8% margin loan. That can be attractive to some people.

You'll notice a new investment in something called Horizon Kinetics Resources LLC. It's a modest investment. We have received some questions about it, which we'll get to later. You'll also note, under Current Liabilities, that securities sold not yet purchased—meaning short positions—have increased. That's something we've been doing as a matter of course, and not just on the FRMO Corp. balance sheet either.

On the income statement, we have been asked about income from investment partnerships, which looks very high at $1.9 million for the three months ended November 30, 2015, versus a couple of hundred thousand dollars for the same period in 2014. That is essentially realized gains from some funds managed. You'll see down below, under Other Comprehensive Income, a ($5.4) million figure. And that, as opposed to realized gains, reflects unrealized losses in market value, since the funds managed went down during the period.

The realized gain item is highly variable. That could be quite low in the next period, just as the unrealized investment holding gains or losses under Other Comprehensive Income could be a large figure in either direction. But that's really just a matter of changes in market value.

The decline in shareholders' equity from May through November, which is about $4 million, reflects the change in Comprehensive Income. And that, really, is a function of the market value of securities interests we have through limited partnerships.

Those are my observations about the balance sheet, which will probably generate more questions. Now I'll turn the discussion over to Murray.

Murray Stahl – Chairman & Chief Executive Officer

Thanks, everyone, for joining us. I'll go through those of our investments which require some commentary, and I'll make a few remarks on the Horizon Kinetics investment management business. As to background, we'll refer from time to time to the ETF/indexation phenomenon. I'll also make some remarks about the cash and where we stand. We'll answer your various questions, some of which are very astute.

Let's begin with the investments. South LaSalle Partners is the Minneapolis Grain Exchange (MGEX). All you have to do is look at the MGEX website to see the open interest and the volume figures. The volume is reported every day and, on many occasions, it reports record volume. Putting that statistic in its proper context, it's worth noting that commodities in general are in a bear market—wheat in particular—and they've been in a bear market for quite some time. Normally what happens in a bear market for commodities is that the volume goes down. But lately, the volume is actually going up. I can only wonder what the MGEX results would be if we were in a bull market for commodities; maybe one day we will be.

In terms of the MGEX fundamentals, the earnings and cash flow are largely a function of the volume and open interest. If you look at the volume and open interest, you can see what's happening. On many days, the volume set an all-time record and, for a number of months, there has been all-time record volume. If I'm not mistaken, the calendar year 2015 was the best year this exchange ever had, so that's pretty good.

Regarding Winland Electronics, the electronics business is holding its own. Its other activity is the exhibition business called EDG. Some number of months ago, Winland made an investment in an EDG exhibition of Beatles memorabilia. I believe that it is close to, if not the most successful exhibition EDG has ever had. The results were better than we thought were even possible, or at least as good as we had any right to believe. We look forward to doing more business there.

OneChicago is too new an investment for much commentary. Nothing much has changed in the single-stock futures business—yet.

After the quarter ended, we made a small investment in the Canadian Securities Exchange (CSE). Few people have heard of the CSE, since it is a relatively new exchange for Canada. For lack of a better description, it is an exchange for the Canadian small-cap market. The Canadian small-cap market is in great disarray because, in general, many stocks that are too illiquid to be in indexes are in disarray.

As most of you know, iShares, which is owned by Blackrock, at one point had a Canadian small-cap ETF. I think, at its high, it had something on the order of $2 million of assets. It's now closed. Not that it's a big deal; I just mention it to show the lack of interest in Canadian small cap stocks. Canada is a natural resource-based economy. There's not a lot of interest in natural resources, since they require capital. Many of those natural resources are developed by small-cap companies, and many of them lack for capital. The investment in CSE could be a very intriguing opportunity, if and when circumstances for commodities change.

Moving on to the Bermuda Stock Exchange (BSX), its biggest product is insurance-linked securities. Since the last time I wrote about this, insurance-linked securities have an even higher open interest outstanding—or total market capitalization—listed on the BSX. I believe, if I'm not mistaken, that the BSX has something on the order of a 70% market share in insurance-linked securities. Accordingly, that's growing, as we had hoped it would. It's still a brand new asset class, and it has a lot of future promise. We look forward to what might be achieved there.

Next I'll talk about the little, almost de minimis investment, on the order of $51,000, called Horizon Kinetics Resources. It invests in equities that are related to commodities and, suffice it to say, at this point commodities worldwide are in free-fall, and equities that are involved in commodities businesses are likewise in free-fall. The world of indexation doesn't seem to have much interest in commodity-related ETFs which, I guess, adds some fuel to the fire.

An investment in any kind of commodity structure, or equities related to commodities, is not for the faint of heart. At the moment, we're starting with a very small investment. Obviously, if on a mark-to-market basis we lost half of the money that we invested, it wouldn't be too damaging to our balance sheet. Hopefully, as the years progress, we will have an opportunity to add to our investment there. We're looking forward to doing that.

It's quite likely that, next quarter, we will have to consolidate Horizon Kinetics Resources on our balance sheet, which is fine. We'll have whatever investment we have as FRMO, and the majority interest is going to be us personally and our various shareholders. It's going to be what it's going to be. It might look a little different, but it's going to be the same kind of magnitude investment, although it'll probably increase a little bit.

At Horizon Kinetics, with respect to our investment management business, we're engaging in two activities that people do not like but which we feel are necessary. First, we're raising a lot of cash. You know what that means: people don't like to pay you to raise cash. It implies that you don't have a positive view of the marketplace, or at least it implies that you don't have very many great investment ideas. It's not one of the steps you take if you want to raise a lot of assets.

You may think that people hate the second one even more, and maybe they do. It is our investment posture regarding the great and stellar investments of the last several years, examples of which are Amazon, Facebook, Netflix, and a list of other similar companies—I can go on and on naming companies of this type. We have none of them. The reason we have none of them is because we're value-based investors. We're simply not going to tarnish our reputations by buying companies that we think have egregious, and maybe fanciful, valuations.

If you're interested in outperforming indexes, obviously you have to own the securities that outperform indices. I gave you some examples of those types of securities and, of that list, we have none. We are simply delighted, as well as proud, not to have them. We could be right and we could be wrong, but we have a certain philosophy that has served us well for many decades, and we're not changing it. We'd rather keep our reputation for being disciplined value investors than be involved in that sort of stock. Time will tell if we've done something sensible or if we've done something foolish. But I think, at the end of the day, it's something rather sensible.

So, that gives you sort of an orientation. Moving on, the cash on the balance sheet, strategically, follows from, as just touched on, what's happening in the indexation world. To a very, very small extent, one might think the indexation world is just a reflection of reality, but the indexation world is actually changing reality in certain ways. That world suffers from what might be a key deficiency: if you observe the world of indexation—and also quantitative strategies, not necessarily indexes—the fees are literally plummeting. The incentive, or at least the money that can be made from a quantitative or indexation strategy, is in decline.

You might wish to place $1 million or $1 billion in a certain index, and I'm sure the index orchestrator would be delighted to take it. Whether or not they're going to make a lot of money on it, however, is an entirely different question. To the detriment of those strategies, for the first time in well over a decade, the incentive structure has now altered.

If the orchestrators wish to make money, they must do something different, which brings us to the problem. The problem is there is nothing one can do that's different that doesn't involve less liquidity. It doesn't mean you will own illiquid instruments; it just means that the indexes, because they employ market capitalization, float-adjusted weights, are dominated by the most liquid securities in the world. Any other security strategy or posture, by definition, has to be less liquid. That's kind of problematic when the investment world is dominated by indexation, which means everybody owns, more or less, the same thing.

If the world wishes to somehow reorganize its investment posture, how can it do so when it has to sell certain securities that other investors are dis-incentivized to hold? The ETF operators can't charge a lot of money for holding them, and many of them trade at preposterously high valuations. It's a big problem.

I dare say, it also affects reality because, with rare exception, the largest and most liquid companies in the world are global multinational companies. What's the common feature, I ask you rhetorically, of global multinational companies? They make their products, and in some cases offer their services, in the cheapest manufacturing areas in the world, many of them in East Asia or South Asia. They export those products and services to the wealthiest countries in the world, one of which happens to be the United States. That can be done only for so long before a point is reached when it can't be done anymore, which means the profit margins reach the maximum limitation.

What these multi-national companies do to the host economy is to remove a certain number of high-paying jobs. They have done this with a view to gaining higher margins, and maybe that's their fiduciary obligation. But, if everyone does it, it's problematic, which is why we're in this situation, at least in the United States, and paralleled, I think, in Europe and some other places in the world. The median household income in the U.S. in the last eight years or so is down by $1,000. That's not the way to achieve a robust economy.

It's one of these paradoxes in which everyone follows their own best interest. There's nothing really wrong with that except, when everyone follows their own best interest, it leads to the tragedy of the commons; it creates a problem for the totality. That's what's happening in world markets and world economies. I don't think it's going to be a pleasant experience for one and all.

Getting back to the cash position, it's higher than ever, and we expect that there will be opportunities for its use. Let's examine, theoretically, why we've made such limited investments. We have an exceedingly modest investment in Horizon Kinetics Resources, which holds some equities. Let's just say, for the sake of argument, we had an investment that was tied to some commodity. It doesn't matter if it's silver, oil, gas, or gold; it's something in the world of commodities. I'll use oil for illustrative purposes.

Let's say we had an investment in a company that was correlated to oil, and that company has its maximum value when oil trades at $60 a barrel. Let's just say that will be the new delivery price—it's not going back to $110 or wherever it was—and let's say that oil is $30 at the moment. Actually it's lower than that now, but let's say that's what it is. Well, if it then rose from $30 to $60 and the investment was tracking oil, obviously it would double. Just as an illustration—and it might happen—what if the price of oil instead went to $12, or $6, and if we still believe the equilibrium price of oil is at $60? The opportunity would then be to make 10x your money.

On the fundamentals, maybe that shouldn't happen, but it's well to remember that the investments are not being made by human beings, for the most part. Rather, the investments are being made by machines in relation to certain formulae, which are based on volatility. By these rule systems, the more volatile securities are required to be eschewed from a portfolio, and few securities are currently more volatile than commodities. Therefore, this sort of investment could get very interesting.

At the moment, an investment in commodity-related equities is not for the faint of heart, which explains why the size of the investment is so small, for the moment.

We've covered Horizon Kinetics, the management company; OneChicago; the new investment in the Canadian Securities Exchange; Winland; South LaSalle Partners, which is really the Minneapolis Grain Exchange; Horizon Kinetics Resources; and Bermuda. We've covered all the main items. Accordingly, if I may, I'd like to move on to the questions.

Question 1

Would you please comment on the potential changes to the regulation of leveraged ETFs, and the potential effect this could have on FRMO's short book as an ongoing strategy.

Murray Stahl – Chairman & Chief Executive Officer

In my opinion—and it's just my opinion, so I could be wrong—I think the SEC is going to do away with leveraged ETFs, meaning that there will still be leveraged ETFs but they won't have 2x leverage. I believe the SEC is going to allow 1.5x leverage. I don't think it's going to be a big problem for us, because some of the functionality in our short strategies, when it comes from the ETF world, comes from leverage, and we may have a little bit less leverage. But some of it comes from unleveraged securities.

I won't reprise what I stated in prior conference calls, but it will be recalled when we talked about the effect of leverage that, if a fund is short, it will have its maximum short position at the low, and, if the fund is long, it will have its maximum long position at the high. That applies whether or not the fund is leveraged. There's a decay rate even in the unleveraged funds. In some cases, if they're very volatile, as many are designed to be, the effect is quite extraordinary.

I think it's actually a pretty good thing if the SEC does away with leveraged ETFs. Incidentally, I need to remark in passing that, even if the SEC were to require or limit leverage to no more than 1.5x, anyone who wants to can easily get more than 1.5x leverage just by using the options market. It will dissuade the aggressive, I think, for no more than five minutes. It will have de minimis impact on our short strategy. It might even make it more interesting.

Question 2

How is the Indian equities product offering progressing?

Murray Stahl – Chairman & Chief Executive Officer

It's not progressing and you need to blame me for that. I stopped the Indian equities product offering, because I didn't like what was happening in the financial markets, particularly what was happening in the world of indexes, ETFs, and quantitative strategies. Now is not the time to show the world yet another way to invest in equities.

The strategy is ready to go and, at some point, we're going to do something in Indian equities. I think that what we plan to do is kind of interesting, but now is not the time for equities. I don't think we would do our potential clients a great service were we to encourage them to invest in another long-only strategy at this time. Consequently, we're not doing it.

Also, to the author of the question, thank you very much for the essay regarding the letters of Ricardo. I'm actually finding it very interesting, and I intend to read it in greater detail when I have a chance. So, thank you very much.

Question 3

What are the current assets under management at Horizon Kinetics?

Murray Stahl – Chairman & Chief Executive Officer

The number I give you is after the sale of our interest in the equity options business. It's something like $7.6 or $7.5 billion. There were well over $400 million of assets under management in the so-called index options business.

Question 4

What type of securities were transferred as consideration for the 1.65% interest in Horizon Kinetics Resources?

Murray Stahl – Chairman & Chief Executive Officer

Basically, equities. As a matter of fact, the only security we transferred was one equity. We bought something that we thought was appropriate for Horizon Kinetics Resources, and we used our cash to buy it which, obviously, was not a large amount of cash. When it settled, we just transferred it in for our 1.65% interest in Horizon Kinetics Resources.

Question 5

Given the large cash reserves of FRMO, why was cash not used as consideration?

Murray Stahl – Chairman & Chief Executive Officer

I suppose you could phrase it this way: in a manner of speaking, cash was used in the transaction. All that really happened is that we bought the securities very recently, we spent some of our cash, and we dropped the security in the fund, as opposed to giving the money to the fund and letting the fund buy it. I guess it's six of one, a half-dozen of the other. I don't know if that makes any big difference.

Question 6

Why such a small investment, given FRMO/HK related people appear to have made much bigger investments into this new opportunity?

Murray Stahl – Chairman & Chief Executive Officer

First, I'd caution you: it remains to be seen if it's an opportunity to make money or lose money. We don't know that yet. Hopefully it's going to be a moneymaking opportunity. As I tried to point out before, since this is related to resources—to be read as commodity-related investments—and they're equities, this investment is not for the faint of heart. We didn't want to expose FRMO to large market value fluctuations. With our own investments, we are somewhat more aggressive. Ultimately, it's not unlikely that FRMO might have a bigger investment at some point in time, but we're just starting. As a matter of fact, it's possible that one day this might be open to other people. At the moment, we're not opening it up to anybody other than people we know personally. It's mostly ourselves and FRMO, and that's the way it is. I hope that answers your question.

Question 7

Can you give your thoughts on two holdings of Horizon Kinetics that have been hit very hard: Dream Unlimited and Dundee?

Murray Stahl – Chairman & Chief Executive Officer

Let's start with Dream. Dream has many aspects. It is a real estate development company in Canada, with much of the land in Saskatchewan. Dream is also a manager of REITs. It actually holds stock in some Canadian REITs that it manages, and it has some miscellaneous assets. It trades more or less at book value right now.

I mentioned earlier that Dream is a small-cap Canadian stock, and it's hard to find a place to trade small-cap companies in Canada. There's no interest in small-caps anyway. Everyone believes that small-cap companies in Canada—as matter of fact, even large-cap companies in Canada—are somehow correlated with commodities. Although there may be the exception here or there, anything and everything related to commodities has fallen very far.

To give you an idea, I don't know if this will make you feel better or worse but, let's take a larger company that's been around for over 100 years: Anglo American. You might be aware that Anglo American has a market capitalization of somewhere around $5.5 billion U.S. dollars. In the last year or so, if I'm not mistaken, it's fallen 80% in value, maybe more. If you overlaid a chart of Dream's stock price on a chart of Anglo American, which is in a completely different business, though it's commodity-related, I doubt very much if you'd notice a difference between the two.

You could substitute Glencore for Anglo American, or Freeport-McMoRan, or similar companies and you'd get the same result. This is what's been happening in the world of commodities.

Dundee is a bit different because it's slightly more diversified. It's basically a conglomerate holding a lot of investments in small-capitalization, commodities-related businesses. What can I say about small-capitalization commodities-related businesses? They've done even worse than large-capitalization, commodities-related businesses. They trade at an even bigger discount to net asset value than your typical commodity company.

The only company that I'm aware of that's involved in commodities—and this is, I think, an interesting point for you—and the stock of which hasn't reacted the way you might think is Exxon-Mobil. When oil was roughly $100 or $110 per barrel, I think Exxon-Mobil was $100 a share, roughly. Now Exxon-Mobil is in the high $70s, and oil is below $30 a barrel.

The earnings of Exxon-Mobil are now estimated, for this year, to be $3 and change. That might be 60% to 70% below what it would have earned had oil stayed where it was. You might think the stock should've gone down 60% or 70%, as did every other commodity related share. However, as a giant, liquid company, its stock is trading at 20x earnings. It's a raw material, and I don't mean the oil. I mean the stock is a raw material as a primary constituent of indexation. And basically it has to be there.

There are a handful of companies that, if they are sufficiently large and sufficiently useful as raw material, might be the exceptions, but there aren't many exceptions. As a matter of fact, if you were to look at a chart of Imperial Oil of Canada, which I believe is something like 70% controlled by Exxon, making it essentially Exxon Canada, you would see very little similarity to the price performance of Exxon, even though it's managed by Exxon and benefits from the same strategy. I think much of that difference has to do with indexation and indexation's liquidity-based inclusion/exclusion rules. So, there we are. I hope you found it helpful.

Question 8

On the last call, there was some conversation about a new fund investment that would soon occur, some kind of concentrated portfolio investment done in a nontraditional way. Can any update be shared?

Murray Stahl – Chairman & Chief Executive Officer

That investment is Horizon Kinetics Resources. I gave a little update on that earlier. The idea is to be concentrated. The standard way of dividing commodity investments is large-capitalization and small-capitalization. But that's not necessarily meaningful. Much more meaningful in the world of commodities is the balance sheet, meaning degrees of leverage. In theory, the leverage could be zero; you might have no leverage at all, or you could have a lot of leverage. If you have a lot of leverage, as many companies do, and commodity prices stay down for long periods of time, they still have to make the interest payments. You can see why that might be problematic.

On the other hand, if there are companies that are either unleveraged or modestly leveraged; in other words, if they have the commodities but they're not producing them—they're in the ground somewhere not doing much—what do you really have? You might have a company with some modest degree of earnings, it's true. To that degree, they're building book value. But you also have, essentially, an infinite call option on that commodity if it produces one commodity, or those commodities, if it produces several commodities. It's the latter that we are interested in.

Let's take oil as an example which, I should warn you, isn't necessarily reflective of what we might have in this fund. Let's say I wanted to buy an at the money call option on oil. Oil is $30 a barrel, and I want to buy a call option exercisable at $30, and I want it exercisable over the course of 20 years. The writer of the option would calculate the strike price as known, the option expiration period of 20 years, the volatility of oil and then ask some truly astronomical sum as a price for that option. But, effectively, you can buy that option in an unleveraged commodity company, and you get it for free. If you can find one that's making some money, if you think about it, it's actually a negative premium.

I would argue that all those kinds of companies, to the degree that they exist, are by definition undervalued. I can't say that there's a tremendous number of them out there, because many companies like to use leverage, but there are some. To the degree that there are some but not many, now you understand why the fund might be concentrated, because we're focusing on those types of companies.

Considering the arithmetic I went through, you'll see that there are two benefits. The first is if the commodity price increases, obviously you're going to get that benefit. The second is that the intrinsic value of the investment itself could rise. Let's say you have 1,000 ounces of gold in your total reserves—that is, not only proved and probable, but also inferred—and you haven't produced an ounce. A year from now, if the price of gold rises by a certain quantity, your reserves might well be valued upwards. Ignoring the price in terms of intrinsic value, but not ignoring the price in terms of upward revisions of reserves, that is another way of getting an increase in your asset value because, at the higher price, more of your physical resource base becomes economic to extract. Higher-cost resources can then be profitably mined, and are moved into the reserve category. That doesn't happen in an option.

Just as an illustration, if I said I buy an option on 100 ounces of gold, that's what it is: 100 ounces of gold. The gold price will go up or not go up. But, if I buy the equity and I think of it as an option, if the gold price were to double, then in this example (again, this is just an illustration) I probably don't have only 100 ounces of gold in the ground anymore; I might have 200, or even 300, which explains how much upside there is. You have the upside from wherever the current price is to whatever the equilibrium price is going to be, if there ever is equilibrium in commodities, and you have the further advantage that there is a lot more of it extractable profitably.

The third factor is the technology of extraction, which is constantly changing, especially when it comes to oil—much less so for gold, much more so for oil. In oil, rarely a month goes by that they can't extract more at a lower cost, and you're getting all that for free.

You might think of it as getting two options, one of which you could never get in a standard derivative transaction. In my hypothetical example, you have the case of the price rising and whatever value results from that, but in a standard option you cannot get whatever reserve revision might occur, both from the increase in price and from any technology enhancements.

Question 9

Can you discuss the departure of Horizon Kinetics' CEO as well as the terms and conditions in which HK's option team was acquired by Neuberger Berman?

Murray Stahl – Chairman & Chief Executive Officer

To begin with, the Horizon Kinetics CEO went with the team, so he's going to be working with the team over there. You can look at it this way: to the degree that the CEO desired to develop an institutional business, the index options business was the institutional business. Again, you might blame me for this change. If you reflect on all that I have written about indexation, and once in a while I even write about options, it didn't seem logical to develop a big index options business when I had all these negative things to say about indexes.

In addition, the index business required trading in large size virtually every single day. And, one day, or maybe even more than one day, it's possible, in the vernacular of the industry, in the precise language of the industry, it's possible, occasionally, to make what we call a boo-boo. When you make a boo-boo, and you're trading literally hundreds of millions of dollars of notional value of options, a boo-boo can be very expensive. You can cover that with insurance, but boo-boo insurance is expensive as well. Therefore, I guess you can blame me; I wanted to avoid the possibility of a boo-boo, and I didn't want to pay the boo-boo insurance. As a consequence, a transaction was organized and subsequently consummated at year-end. And that's what's happening with that.

Horizon Kinetics and Neuberger issued a press release regarding that transaction. Basically, we're going to share in the revenue and upside, to some degree, for some period of time. If there is a boo-boo, it's not going to affect us, at least not directly. I think it was a good deal for us, or at least I hope it was a good deal for us. It lowers our assets under management, but it lowers our expense structure yet further. Bear in mind, it's certainly part and parcel of the larger indexation business, where the fee structure is generally in free-fall, but I already offered some comments about that, so you know my position. I hope I made myself clear.

Question 10

Would you comment on Horizon Kinetics' position in Rouse and the $17 cash bid by Brookfield?

Murray Stahl – Chairman & Chief Executive Officer

The bid is for cash of $17. The stock, at least the last time I looked, was trading above $17. Brookfield organized a committee to value Rouse at arms' length, I presume. Since the stock is trading above $17, apparently the market thinks there might be a higher bid by Brookfield. I guess that would really come from the valuation committee. I'm not going to play any part in that; they're going to do what they're going to do.

But, obviously, it's always good to get a bid for something, and there's the bid. It's not unlikely, at least if you believe what the arbitrage community has done to the stock price, or at least as of the last time I looked, maybe an hour or two ago, the arbitrage community believes there's going to be a higher price, and I sure hope they're right.

Question 11

How may willing and able shareholders be of assistance to management and the success of the company? Bearing in mind that in the long run we are all dead, how do you see the future of the company? Under what circumstances and conditions would you pay dividends in cash? Would you consider enhancing FRMO's credibility of our shares by a reverse split such that our wrapper is not a low single digit but instead a two, or better yet, a prestigious three digit price?

Murray Stahl – Chairman & Chief Executive Officer

I'll address these questions in reverse order, if I may. "Would we consider enhancing a reverse split?" Yes, I think we would consider that. It's something we need to discuss. I guess the tradeoff is you get less liquidity in the shares. But then again, at the moment, our shares aren't outstanding for their tradability and liquidity. Hence, maybe it's a good idea.

Regarding payment of dividends in cash, at the moment, we're not planning to pay dividends in cash.

Steven Bregman – President & Chief Financial Officer

It's interesting, though. The value of cash, to someone of a certain perspective, is going up by the day.

Murray Stahl – Chairman & Chief Executive Officer

That's true. Yes, thank you, Steve, for bringing that up. Let me tell you what we think about cash. Cash, in principle, is the ultimate risk-free, non-volatile asset. Whatever is happening in the marketplace, the cash stays the same. From holding it in whatever instrumentality you choose—a government money market fund, a T-bill, or whatever it happens to be—you get your one basis point a year, or something like that.

But that's not all there is to it. To us, cash is an active asset class investment. It's not a passive investment and it's not a reserve. It's active in the sense that the purchasing power of our cash is rising a lot. We gave an example in the Horizon Kinetics Resources discussion about commodities and how fast the purchasing power can rise. Take any commodity, or any equity related to a commodity, look at it for two minutes, and you can see how rapidly the purchasing power is rising.

With even a small amount of cash, if things keep going at the same rate for not very many more days, which they might, a small amount of cash has incredible purchasing power. You could take a small risk with a small amount of money and undertake what might be, at least from the balance sheet point of view, a truly transformative transaction.

That's related to the next part of the question: "Bearing in mind, in the long run, we are all dead, how do you see the future of the company?" What we'd like to do next, if we can, is to acquire control of some operating company, which is one of the reasons we have the cash there. It might not even cost a lot of money, and we might even be willing to use a certain amount of leverage in relation to it.

The only time you're really going to be able to do something like that is when the world of equities is problematic. If there's a possibility that the world of equities might be problematic, you have to have a lot of cash on the balance sheet. If we had control of some company that could produce some relatively robust return on equity, and provide us with a certain amount of cash flow, it would be transformative for us, because we'd have a lot more cash flow with which to make investments.

It's not inconceivable that at this time, unlike 2008, the world of equity investments might stay depressed for a considerably longer period of time. You'll recall that in 2008 it was possible to lower interest rates. I don't think that's possible at the moment. We might be looking at a very,

very different outcome and, therefore, a radically different opportunity set. I hate to be morose about opportunities, but in times that are very painful for many people, for those who have a lot of cash on the balance sheet, it can actually be very pleasant because their purchasing power is rising literally by the day. Some good things might happen to us; therefore, we're going to retain our current balance sheet posture.

The last part of the question asks: "How may willing and able shareholders be of assistance to management and the success of the company?" There might come a time—though I don't know if it will—when you'll see a few more funds on the balance sheet, and then we might like access to additional capital. I say "might," because I can't guarantee there will ever be such a time. But it's possible, if the right opportunity came along, we might wish to draw on further capital. I can't guarantee it's going to happen, but it's not impossible that it will. We'll just wait and see when the opportunities arise. At the moment, we're not advertising any opportunities, but that might change.

Question 12

How are you looking at the future prospects for commodity markets, especially oil?

Murray Stahl – Chairman & Chief Executive Officer

We talked about commodities markets, but it's worth making some other points. In 2008, if I'm not mistaken, the low on West Texas Intermediate crude oil was something like $38 a barrel. Now we're at about $28 for West Texas Intermediate, so it's considerably lower, with possibly no end in sight. Although there's a lot of oil inventory, it's hard to imagine that the prospects for commodities as we view them today are significantly bleaker than they were in late 2008 to early 2009, when many believed it was basically the end of capitalism as we know it. It seems to me that something else is going on, and the indexation machines are working overtime. That's going to lead to opportunities, even if those opportunities don't exist today.

Question 13

Could you provide some color around the increase in unrealized investment holding losses as outlined in Other Comprehensive Income?

Murray Stahl – Chairman & Chief Executive Officer

We don't have that many losses. In the few closed-end funds that we still have, there are some book value losses. However, they're not really losses, meaning they're not losses in relation to the cost at which we bought the assets. When you hold a closed-end fund for many years as we did and, to some degree, still do, as the fund sells securities, if they passed out realized gains, there's a change in the book cost of the investment. If you hold it long enough, and the company passes out enough realized gains, it looks like you have a loss, but you really don't. The accounting is done that way because you don't want to pay taxes twice on the same profit, but it looks like you have losses.

Thankfully, we really don't have a lot in the way of losses. I think we've been pretty disciplined about buying. Actually, in a very, very minor sense, our $51,225 investment in the Horizon Kinetics Resources Fund LLC is at a modest loss right now. I guess that's theoretically part of it. But we don't have a lot of losses.

Question 14

Would you share your thoughts on the assertion made by some investors that bond ETFs actually help market liquidity?

Steven Bregman – President & Chief Financial Officer

I'll take this one. It might be true that bond ETFs add market liquidity in one direction, but not in the other direction. Evaluating whether a security or a sector is overvalued or not is much easier with bonds because they're much more amenable to objective valuation, because there are many fewer variables. I could suggest that a company like Amazon is overvalued, and I could have a robust discussion with somebody who could legitimately argue the opposite case.

In fact, I could even argue their case for them, as in moot court. I could say, "Steve, it's really not undervalued. You just have the wrong assumptions. You think the revenue growth is only going to be X, and I think it's going to be 1.2 times X. You think growth is going to slow down in three years, and I think Amazon could do this for 10 years. We both know that, with the stroke of a pen, Jeff Bezos could make the margins not some fraction of 1%; he could make them 2% or 3%. Then there's the matter of the terminal P/E, and you think 12x is the right number, and I think 25x is the right number." It's very difficult to achieve any kind of absolute agreement on equity valuation, even on overvalued stocks.

It's much easier with a bond, because what are your variables? You're either going to get paid your 100 cents on the dollar by a certain date, or you're not. You're either going to receive a certain coupon, or you're not. It's easy enough to figure out. Typically, the financial figures underlying the bond—the amount of cash available, and seniority—are fairly well observable.

Here's an example of how the ETF flows might assist liquidity. There are some ETFs, for instance, that are based on some of the more exotic indexes, such as emerging markets high yield. In the iShares Emerging Markets High Yield Bond ETF and others that follow the same sort of index, the largest allocations are to Russian Federation bonds, and among the top 10 allocations you would find the Republic of Lebanon bonds. I'm using figures from a few months ago, so they might have changed. But, a few months ago, you could find Russian Federation 15-year bonds with a yield to maturity of 3.66%, which is just about what a 10-year IBM AA-minus bond trades for.

Most people, if I ask them at what price they think Russian Federation bonds might sell, without telling them anything else, they'll pause for a moment and say, "15%." They understand that 3.66% is absurd, even though that's how those bonds are priced. The Republic of Lebanon seven-year bonds actually borrow more cheaply than Wendy's does for its 10-year bonds. Thus, we're talking about basically a 6.6% yield for the Lebanon bonds. Without getting colorful about what Lebanon looks like, I'll say, if you go to the Embassy of Lebanon website, the U.S. Embassy, where they post financial data, the last time they posted, or were able to post GDP information was, I think, in 2013.

Clearly, there's plenty of liquidity, and it's very assistive of those nations raising capital. The question is—and I'll leave it for you to answer, with some reflection—what if a bunch of investors in an ETF wanted to sell a sufficient number of shares such that the ETF had to engage in redemptions, basically it had to sell those bonds? Do you really think they'd get those prices if they wanted to sell the bonds?

To give you a sense of how the index flows work, just as a thought experiment because it doesn't actually work this way, but let's say that this ETF has only about $230 million of assets under management. Because it's easier to see in something small, let's say that a relatively modest sized public pension plan with, say, $10 billion—which wouldn't make it anywhere near the top 300—was recently advised on asset allocation. It was told to put a one-half of 1% investment in this ETF because, based on historical statistics, the portfolio was just missing that little piece of the pie. That one-half of 1% investment would actually improve the risk/reward curve of the ETF, yet it could end up being something like 20% of that fund. The pension fund wouldn't actually do it that way, because according to best practices, it shouldn't be too large a proportion of any given fund. But they're not the only party making that decision.

Effectively, when the ETF gets an inflow like that, it has regulatory rules by which it operates. It has to deploy that capital; therefore, it buys. That's how the money goes in. But the question is: How does it come out? You can think about whether there's actual liquidity on the way out.

Murray Stahl – Chairman & Chief Executive Officer

If I may, I'd like to add to that, because this is a really important subject. As per Steve, if I started an ETF, and I were buying investment grade-rated bonds for that ETF, I'd buy a certain bond and I'd raise a lot of money. Obviously, that might affect the cost of borrowing of a given corporation whose bonds might be included in the fund by making it easier for them to borrow. The bonds might trade well and have more liquidity than they would otherwise.

Now let's assume, in a less salubrious environment, that the bond in question in the investment grade-rated fund gets a downgrade. If it were in an individual portfolio, as opposed to an ETF, if it were you and I who had that bond in a portfolio, just because it gets a downgrade, we're not really required to sell, unless we have to fund a redemption. But an ETF, if it represents an investment grade-rated index, even in the absence of redemptions, would have to sell, because it's an investment grade-rated fund, and that bond is no longer investment grade-rated. Therefore, the ETF has to sell it.

The problem with that is, if we had that bond in an actively managed fund, the world might not even know that we own this bond. And even if they did, we wouldn't necessarily be required to sell it anyway. Even if we were required to sell it, the world would only find out at that moment. But if it's a disclosed fund such as an ETF that's completely transparent, everyone knows it has X par value of a bond that is no longer investment grade-rated, and which must be sold. The ETF doesn't have a lot of time in which to sell it. Traders are able to take advantage of the fund in a way that they couldn't possibly do to an actively managed portfolio.

Anytime a security is required to be sold in a not-so-wonderful environment, there will be various types of illiquidity problems. Why should some other manager or trader be the first to buy that bond? Wouldn't it be better to be the last person to buy? But somebody has to be the first. The bond to be sold might be of a size sufficiently large that it's beyond the ability, or maybe the desire, of a bond manager to buy the whole tranche at that moment. Hence, there could be real liquidity problems. We've seen examples of that already. It even happened to an actively managed fund; thus, you can imagine what's likely to happen to a passively managed fund.

Maybe this even relates to our AUM at HK, but we haven't bought a high yield bond in so many years we can't even remember the last time we bought one other than to say it was years ago. We probably could have raised a lot of money in a high yield strategy, and had higher assets under management, but we just wouldn't do it, because the risk/reward really wasn't there, and we don't want to subject our clients to that. In our humble opinion, this is going to be a very serious problem, and it's beginning to happen right before our eyes.

Incidentally, a propos of something else, I should mention that we've written a lot about indexation, and we've collected and printed in a book most, but not all, of the essays we wrote on the subject in 2015. If you email, write, or contact us in some way, we'd be delighted to send you the *2015 Compendium Compilation*. By the way, the reason it's "most but not all" is because we wrote more material subsequent to the day we had the 2015 book printed. Accordingly, I guess next year we'll include the remaining 2015 material in the 2016 compilation.

Question 15

Winland indicated in a footnote that it might be following what looked like a platform strategy in the future. Do the issues surrounding Valeant and the collapse in the stock price of Platform Specialty Products engender any concern with that path?

Murray Stahl – Chairman & Chief Executive Officer

I can assure you that what Winland called "the platform strategy" has nothing whatsoever in common with Valeant; it has nothing to do with that. And it has even less in common with

Platform Specialty Products. It's just a choice of words that refers to something different. At a future Winland conference call, I'll leave it to them to describe what they meant, if they choose to do so. But I can assure you that it had nothing even remotely close to do with Valeant or Platform Specialty Products. At the moment, it's just a word, and maybe it's not the best choice.

Question 16

Is there any opportunity for FRMO in the disastrous MLP or high yield debacle that was so well forecasted by the firm?

Murray Stahl – Chairman & Chief Executive Officer

First, thank you very much for the compliment. We don't get very many, so when we do, I'm very happy.

Regarding high yield, it's very early. All we can say is the yields to maturities are higher than they were. But, in more detail, here is why there are not a lot of opportunities in MLPs at the moment. Let's just say you were looking at a high yield index. And, for the sake of argument—I'm using round numbers; these aren't exactly the numbers—say the stated yield to maturity of a high yield index is 6%. It's not 6%, though. Why? Because, if you go through the whole list of bonds in the index, you will find some that have a 70% yield to maturity, an 80% yield to maturity, even 90%.

If the yield of the index is 6%, that's a weighted average that is inclusive, obviously, of the egregiously high yields just mentioned. When bonds have yields to maturities of that level, or even much lower numbers, the market is telling you—and the market is right—that they're not likely to pay that coupon. You're not actually going to get a 70% annualized return from that bond; a figure such as 70% is actually saying that you're not getting a return. There will be a default at some point. Accordingly, the yield to maturity, even though on paper it looks higher than what it was historically, is not really that much higher. That's the first problem and that's not even the biggest one.

Here's the second problem. Let's ignore what I just said, that the yield to maturity looks higher than what it really is. Let's just make believe the yield to maturity is really 6%. If I'm the greatest high yield analyst in the world, which I don't claim to be, but let's say I were, I'm still going to be imperfect as a human being. Consequently, the question is: how many errors will I make?

If I buy 100 bonds and, on average, they yield 6% to maturity, and I make no mistakes, I'm getting a 6% yield to maturity, just by definition. Now, let's say I'm right 80% of the time, which means 20% of the time I'm wrong. Okay. The question is: how much loss do I experience the 20% of the time that I'm wrong? Because, basically, in today's interest rate world, excepting those bonds that trade at egregious yields to maturities, everything that's creditworthy is trading near par. Therefore, we are going to imagine that we're not buying bonds on the verge of default, we're buying bonds that, give or take, trade near par. And they're yielding 6%.

Let's assume we're wrong on 20% of those bonds. If we have a 20% average loss—which is not even big—on 20% of the bonds, 20% of 20% is a 4% portfolio-level loss. So, subtracting four percentage points from the stated 6% yield to maturity, we now have, from the greatest analyst in the world, a 2% realized yield to maturity. Why would you buy high yield bonds when, even if your analysis is truly brilliant, to the level that almost nobody's analysis is, you're earning 2%?

What if the loss ratio is not 20%? What if it's 25%, or 30%? Or what if the loss ratio is 20% of the portfolio's bonds, but the loss magnitude is not 20%, but 30%, or 40%? What if it's 50%? And so on and so forth. Play with all these combinations, and see that, even with brilliance, it's very hard to earn an acceptable rate of return for the risk. The only way to earn an acceptable return for the risk would be if you were faced with a high yield index in which a goodly proportion, maybe 50%, of the bonds, which is really the opportunity set, were trading well below par.

Why is that true? Let's say there were 100 bonds in the index, and you bought the whole index, and they were trading at 50% of par value. Let's say half of them defaulted and went to zero. In reality, when bonds default, they rarely go to zero. It does happen, but maybe the defaulted ones will sell at $0.25 on the dollar, on average, and that might be too low. The other bonds that don't default will mature. Thus, on half the bonds, you get double your money. On half the bonds, you lose 50% of your money. So far, even ignoring the coupon income, you already have a positive rate of return.

As far as the interest income, a 4% or 5% coupon bond trading at 50% of face value will have a very high income yield. Add that to the principal rate of return already embodied in this hypothetical example, and your realized total return or yield to maturity would certainly be above 10%, even at the 50% individual security investment failure rate, which is a pretty robust rate of return. That's what you need to get interested in high yield. We're not there yet; we're not even close to there yet. The fun and games haven't even started.

Now for the MLPs. The MLPs have two big problems. The first, which is not even the more serious problem, is that they were marketed as safe, nonvolatile investments, which they have proven not to be. The second problem is that much of their dividends—and I think their dividends were, and remain, unsustainable, but set that aside—were return-of-capital distributions. From the point of view of those who bought the ETFs or indexes, what a wonderful world this is: you're getting a dividend, and much of it is exempt from taxes, because it's a return of capital. True enough.

But when you get this return of capital element, it reduces your tax basis, because they're returning some of your capital. If you hold them long enough, eventually your MLPs will have a tax basis of zero. So when you sell them, or if you tried to today, albeit, at losses, you might even end up paying taxes on them. When people figure out that they're paying taxes on securities on which they have holding period losses, I don't think they're going to be too pleased. And that's one of the things that's on track for happening.

However, as bad as that is, that's not even the worst of it. Worse, still, is that the pipeline sometimes becomes obsolete. It becomes obsolete in two ways. First, they find oil in a certain region of the country. Sooner or later, they exhaust that oil and they move on to some other region of the country. Your pipeline, at least in that location, has become semi-obsolete. You have to hook into some other pipeline system or extend the pipeline or do something else. It's not an investment that's free of capital expenditure. That's the first issue.

The second problem is, if the price of oil or gas falls to sufficiently low levels, your MLP can't charge the same transportation differential it charged beforehand. Thus, even to the extent that customers had take-or-pay contracts for capacity, and the MLP might even be able to hold them to it for a while, if those customers go bankrupt, they certainly can't be held to the contract. If they don't go bankrupt, sooner or later the contracts expire, and the MLP has to renew them at much less favorable rates. It's really that simple. To the degree that there's competition in pipelines, and it does happen in some regions, and you don't want to be reasonable about the tariff that you charge for transportation, the oil and gas company might go to one of your competitors.

In any of those instances, if the price of oil goes lower, ultimately, less hydrocarbon product is being transported. You are transporting that product at a lower rate, which means lower revenue, but the cost of operating the pipeline is more or less the same. You have a business with a lot of fixed costs and not a lot of variable costs. If the revenue shrinks, it is extraordinarily painful. Add to that the fact that a lot of these pipelines are highly leveraged, and you have the makings of a real disaster. That's what's happening right now. Every penny per barrel of oil or per McF of gas that the price goes down adds disproportionately to the pain felt by the pipelines and the MLP shareholders.

The idea of an MLP is not necessarily a horrible idea; it's just that it isn't what it was described to be, meaning that the indexes in no sense behaved the way they were supposed to behave. They were designed to be low-volatility instruments for persons desirous of raising income, but they're not suitable for that kind of person. If you're the sort of person who understands the risk, and you're willing to take the risk, knowing this is cyclical—and, by the way, not a few master limited partnerships are going to have to reduce their dividends, and maybe one or two are going to have to even eliminate the dividend—I don't think the shareholder base is ready for that.

I expect more of the same, at least in the short run. As far as we can see, it's too early for us. But we're looking. It doesn't hurt to look, so that's what we're doing.

I think that exhausts the list of questions that we received. It only remains to conclude by thanking you for your continued interest in the firm, and thanking you for joining us in the conference call today. We intend to reprise this in about 90 days, and we look forward to your insightful questions at that time. So, for the moment, we bid you good afternoon. Thanks so much.

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