FRMO Corp. Q1 2017 Conference Call
Tuesday, October 18, 2016

Operator

Ladies and gentlemen, welcome to the FRMO First Quarter 2017 conference call. As a reminder, today's call is being recorded. At this time, I'd like to turn the conference over to Thérèse Byars. Please go ahead, ma'am.

Thérèse Byars – Corporate Secretary

Thank you, Lisa. 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.

The statements made on this call apply only as of today. The information on this call should not be construed to be a recommendation to purchase or sell any particular security or investment fund. The opinions referenced on this call today are not intended to be a forecast of future events, or a guarantee of future results. It should not be assumed that any of the security transactions referenced today have been or will prove to be profitable, or that future investment decisions will be profitable or will equal or exceed the past performance of the investments. For additional information, you may visit the FRMO website at www.frmocorp.com.

Today's discussion will be led by Murray Stahl, Chairman and Chief Executive Officer, and Steven Bregman, President and Chief Financial Officer. They will review key points related to the 2017 first 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

Thank you, Thérèse. Good afternoon. As you might have noticed in the past several reviews such as this one, there's less and less for me to say. The reason isn't by accident. You'll also recall that since we simplified the structure and transactions between FRMO Corp. and Horizon Kinetics not all that long ago, FRMO's revenues really come, now, as a percentage of the Horizon Kinetics revenues, so that's essentially a line item. And then there's the equity interest in Horizon Kinetics and that's what that is. So, as to most of the periodic changes one will see in a conventional sense looking at the income statement and the balance sheet, there really isn't that much of significance. So, if you start with revenues this time, and people do that, you will see that the August quarter revenues from consultancy and advisory fees are down about 27%. That's simply a function of the fact that the assets under management (AUM) at Horizon Kinetics are lower. And if you took the August 2016 firm-wide AUM and compared it to the August 2015 AUM, it's actually down 27%. What else was going on? On an average weighted basis, 52% of FRMO's assets between August 2016 and August in the prior year are in cash and cash equivalents. In that sense, the fact that retained earnings are up 5% is not bad. But really, there's not much that is going on in terms of those superficial observations.

What's really going on, the biggest changes one might see in the balance sheet, in terms of line items, are that in this quarter's balance sheet you'll see three new investments. Under Total Assets, there are investments in Digital Currency Group, in CNSX Markets, and in Miami International Holdings Inc. For the moment, that's where new investing is being done. Some items you can see, and some you can't see. But in terms of future optionality, that's where active investments are providing for future optionality. And, of course, there's the cash, because cash is almost the ultimate source of optionality, because you never know what will come before you.

So, I don't really have that much to offer, other than those. The current investments being made now, obvious or not obvious, are where future growth can come from. Investments that are more strategic. It's not what you're going to find from an accountant's view of the balance sheet and income statement. So, that is my preparation for Murray to speak about what we'll call the portfolio.

Murray Stahl – Chairman & Chief Executive Officer

Thank you, Steve. I'll divide my remarks into two parts. First, I'll talk about some minor items. The reason they're minor is because the major points I wanted to make are covered in the questions submitted in advance that are quite good and touch, more or less, on the major points I wanted to make. So, either I did a very bad job at the annual meeting, and it was left to the shareholders to figure out what the main points were, and they're asking me questions, which of course I'll answer; or I did a very good job, and now people know what the main points are, and they just ask the questions anyway. I'm sure it's the former, not the latter.

But, in any event, let's start, as always, with the balance sheet. The cash is $50 million, which is really important. There's a limit to what kind of return on equity you're going to have if you carry $50 million of cash. As you know, for the last couple years, we've been doing the most we possibly can to get the cash balance as high as we possibly can, because of the narrowing of the opportunity set in investing. In our managed accounts, we've been carrying a fair amount of cash, which some people find disconcerting. It certainly doesn't help in raising assets, because people conclude that you don't like your own opportunity set which, to a degree, is true, and therefore they say, "Well, if you're not going to use the cash, or you don't see a lot of opportunities, we'll take the money away and we'll go to a place where they see that there are opportunities."

Ironically, even though we have a lot of cash, if you look at some of the portfolios, we actually have remarkably good performance, because we're going back to our roots. In other words, historically, we never strained ourselves to invest all the money that was entrusted to us. What we do right now is to basically invest what we think can be invested, and the balance stays in cash. We regard cash as a strategic asset that's available to be deployed when opportunities call for it.

Another point regards our practice of selling short certain types of securities. As usual, there's a big gain. It's actually a larger gain than you see because we're using a greater range of instrumentalities in the realm of path-dependent ETFs—more about that when I talk about indexation. Some of those instrumentalities happen to be options, which have an expiration date. The realization of the profit comes at the point of option expiration. We used to keep a running tally of how much money we made over the years using this strategy, which is simple enough when you're talking about a nearly 2-year set of options that have yet to expire, but time has moved on. I guess we could still do it, but that would now require an accountant. You can no longer tally the cumulative gains just by looking at the balance sheet.

In round measures, we funded a lot of investments wholly in this area. And, as far as we're concerned, this is a fertile area to invest in. The amount we've committed will fluctuate from time to time for a variety of reasons, not the least of which is that sometimes we have no choice. Options expire, and we have to close positions. Therefore, the proceeds end up going into the cash balance rather than figuring in the notes of securities sold short proceeds because, once we close the positions, they're no longer short sale proceeds, even though the resultant cash might remain on the balance sheet.

Even though we say the opportunity set is narrowed, in a certain sense there are strategies that we have as products that are worth paying attention to. For those who don't know, one of the Horizon Kinetics fund vehicles is a bond fund that, at opportunistic moments, can sell put options and collect the premium income, assuming we don't get any securities put to us. Right now, we're not doing very much of that but, on the bond side, we're doing some very interesting things.

There are a whole series of bonds that technically are not investment-grade rated, but I think there's very little prospect of negative credit events in them. The bonds are callable, but they have make-whole provisions. They're very unlikely to be called in the foreseeable future, because it would be too expensive to do so, or it wouldn't make a lot of sense to the issuer. We're running with a three- to four-year average maturity, which is letting those investments roll down the yield curve. In the world of bonds, it actually provides a fairly robust rate of return, with the opportunity for more, with a fairly short maturity structure, which could be pretty good if rates went up. I don't want to give the idea that it's going to change our profit-and-loss statement, but there will be more strategies of this type that we'll be talking about in the future.

We basically returned to our roots—where we were in 2006-2007—we are contrarian, opportunistic investors, and we're not going to hold ourselves to a an inflexible model or standard. We will be eclectic when that's called for, and we're putting our own money into these investments. If we have a lot of cash in client accounts, we have a lot of cash in our own capital as well. All we're doing is eating our own cooking; we don't ask anybody to do anything that we're not prepared to do as well.

So, that covers the minor points. The major ones are all covered in the questions we received. Oh, actually, I forgot one minor point, which is not even so minor. Among our various investments, I should have mentioned the exchanges. For us, they're strategic investments. We think that the wave of the future, whether it comes in the form of consolidation or in the form of new asset classes, will be in the small exchanges. It's a minor point, but I just want to touch on it.

If you go on the website of the Minneapolis Grain Exchange (MGEX), which is the investment that's held in South LaSalle Partners, for those who might recall, you will see that they executed their first carbon emissions credit trade the other day. If it works out—and we are hopeful that it will—MGEX won't be trading solely wheat anymore; it will be wheat and carbon emission credits. Carbon emission credits can ultimately be a unique and robust asset class that has an obvious correlation to energy, but which is actually completely different. Some might even argue that it could be used as a socially conscious investment.

That is just one example of what's possible in the exchanges. It's early yet, but it's a brand new asset class. And it might prove to be very important. That concludes the minor points; now to the major ones, which I'll cover while answering the questions.

Question 1

What happened to the HK Hard Assets LLC? This no longer shows up as a current asset.

Murray Stahl – Chairman & Chief Executive Officer

The HK Hard Assets doesn't show up as a current asset as a separate line item, because we're now consolidating that investment, so it's included in Other Investments. To the extent that not all the money in HK Hard Assets is FRMO's property, on the liability side, there's a contra non-controlling interest, which on this balance sheet, is $4.619 million. That represents the amount of money that other people have invested in the HK Hard Assets. Who are the other people? They include myself, Steve, and the other Horizon Kinetics partners.

If you want to know more about it you will find some further detail in Note 4. Unfortunately, it doesn't tell you as much as we would like. But you can see that FRMO has a 7.38% interest in HK Hard Assets as of August 31, 2016, with a fair market value, according to this document, of $437,067. If you take the $437,067 and divide it by 0.0738, you will get the market value of HK Hard Assets. I don't want to mislead you; that's not the size of the fund; it's actually bigger right now. Subsequent to the end of the first quarter, the Horizon Kinetics partners have been putting more money in.

There are many interesting strategies to employ in certain types of hard assets. Let me elaborate. Ordinarily, a hard asset is related to commodities, and some might call it an alternative asset. But we don't call something an alternative asset just because it might or might not be correlated with the S&P 500—we don't regard that as an alternative asset. Why? Because for any asset—especially if it's a corporation—if the securities do well, sooner or later the corporation will issue more shares, because they want to have access to low-cost capital.

In that sense, a corporation, in a certain way, is almost like an adversary. Although you want the corporation to do well, and you can't blame them for opportunistically issuing securities, if you're an owner, that's not always in your best interest. Although, if they can issue securities cheaply enough, maybe it is.

For us, a true alternative asset is a rare company that's not likely to access the capital markets. Therefore, in the long run, the behavioral characteristics will be based on a certain scarcity value. That's kind of what we're looking for, scarcity value of a hard asset, encased in scarcity value of corporate structure. That's unique and not replaceable, and there's not much of that around, but there is some, and we've been making some investments.

The reason for consolidating this investment is that we wanted to give you a sense of the capital available to us. If you look at this balance sheet, you'll see total assets of $117-plus million, which I think is a record. But even that figure doesn't really tell you how much is actually available to us, because we have investments in certain funds that are, by no stretch of the imagination, fully invested. Those funds, in addition to the un-invested portions, have access to credit lines, which we've never used. And, in point of fact, FRMO and its various subsidiaries have access to credit lines we've never used.

When you add it all up, there's quite a lot of capital available to us. To the degree that we can give you a sense of what our accumulated buying power is and how much it's growing, it's actually growing quite considerably. To understand why it's an important part of the balance sheet for us, let's go to the next question, and maybe that'll give you some sense of it.

Question 2

Steve Bregman has enunciated a view (recently, at the fall Grant's Conference) that indexed ETF products are artificially inflating the valuations of many larger and mega-cap U.S. equities. Does FRMO have a timeframe for when this valuation gap might recalibrate, and what might be the catalyst?

Murray Stahl – Chairman & Chief Executive Officer

Excellent question. We don't know the answer to that. But it occurs to us that from a societal point of view, it would be a danger if it recalibrated all of a sudden and went to what's called normalcy. As you know, when these shifts happen, they never really go to normalcy; they always go beyond, to some extreme undervaluation, which is why a contrarian investor piles up all this cash and waits for it. This time around, however, it might be far more complicated than that. We're in the process of writing some other research to elaborate on that topic, some of which I'll share with you today.

It might not recalibrate. I'll give you a couple statistics to explain why I say that. There is a website called the National Debt Clock maintained by USDebtClock.org. It offers a whole series of fascinating statistics. The number I'll call attention to is the figure for the total debt of the

United States of America. What does that include? Everything from United States Treasury securities to Fannie Mae securities to mortgages, student loans, credit cards, auto loans, you name it. And it comes to $66.5 trillion.

As a footnote to that, when I was writing about this the other day, that figure was $66.4 trillion. In the several days that have elapsed, it increased by $100 billion, which should tell you how serious the problem is.

Also on this website is another piece of information: the interest paid on the total debt. As near as can be calculated by these sources—and, by the way, the data sources are reputable and include the Federal Reserve. You can quibble with it, but it's the most accurate number anybody has. We don't get it directly from the Federal Reserve; we get it from this website, which in turn gets it from the Federal Reserve. So, the total interest assessed on an annual basis, as far as we know it from this website, is $2.517 trillion. That's trillion with a T, just like the total debt of $66.5 trillion is trillion with a T.

To crudely calculate the interest rate, take the $2.517 trillion, divide by $66.5 trillion and, in round numbers, you have an interest rate of 3.79%. Obviously, short-term Treasuries yield basically nothing, whereas at the other extreme, credit card debt is very expensive, so weigh everything out and you get roughly 3.79%.

This website has a forward-looking function and a backward-looking function called the Time Machine. If you click forward a few years, let's say to 2020, assuming everything stays constant (and who knows if it really does), the total debt should be not far from $79 trillion. Some say that with 25 basis points per year increases over three years—I'm making believe that 2016 is over and we're in 2017, so I'm taking a bit of liberty but not much—let's say, in 36 months or thereabouts, interest rates will be 3% higher. And let's assume that the yield curve retains its current shape so that all debt yields are just three percentage points or 300 basis points higher.

In that scenario, we wouldn't be paying 3.79% on debt; in principle, we'd be paying 6.79%. Except we wouldn't have $66.5 trillion in debt, we'd have, as near as can be calculated, $79 trillion of debt. What is 6.79% of $79 trillion? Well, I won't tell you. You can figure it out for yourself, but it's a lot of money. It is so much money that it would easily be more than 25% of GDP, even if GDP grew at a forecasted rate of 2% to 3% a year.

You could argue that—I'm not one of those who would argue this because I'm not a global macroeconomic theorist—but, one could argue that if they raise rates, maybe it would cause a recession, or maybe a recession would happen anyway. I have no idea if it's going to happen or not. I'm simply saying that recessions happen from time to time. If it were to happen, and if it took a year or two to resolve, we might not be at a $20 trillion GDP; it might be like the current $18 trillion level, or maybe even less at $17 trillion or $16 trillion. Then we've got big trouble.

Why give you this elongated macroeconomic analysis when we're not macroeconomic analysts? The idea is that the catalyst, ordinarily, for recalibration of excess valuation in indexes, is interest rates. But they're not in a position to materially raise the interest rates. What might happen is that interest rates do not go up and, if they don't go up, the indexes might not recalibrate.

What might happen could be similar to what occurred in the 19th century when returns on most assets were unsatisfactory. There were a handful of investments in the 19th century that had spectacular rates of return, and many more that had less than mediocre rates of return. In our world today, we're looking at the world through the index lens. The actions of governments around the world during the last few decades that include lowering interest rates, fiscal stimulus, reducing tax rates, and all sorts of related stratagems, made it possible to have an index with a well-diversified portfolio where not everything went up but most asset prices went up.

Now the government is clearly losing that faculty. We might be in a world where not very many securities go up at all—only a few go up. At Horizon Kinetics, we're able to construct funds that have very robust rates of return, even as we have the highest cash balances we've had in years. You don't need a diversified portfolio; you just need a handful of good investments. You can actually have a lot of cash and still have a very good rate of return. Historically, that wasn't possible.

In the stimulus world, more or less everything went up, to varying degrees, some more than the market, some less so, some at market rates of return. In that environment, cash would lower your rates of return. Now, cash might not be lowering the rate of return. What might drive most investments are fundamentals, and the fundamentals might not be so good, not because the companies are really bad. It's just that most of the big companies in your index dominate their industries, which is ordinarily a good situation. The bad part of it, though, is they've saturated their industries. If they've saturated their industries, although they dominate them, the chances of gaining additional revenue from their existing businesses are small.

The recalibration, so to speak, might just be that people come to the realization that the index will only provide an inadequate rate of return. I don't mean to say an inadequate rate of return relative to the risk that one takes from buying the index; it's just going to be an inadequate rate of return. There's not going to be a lot of money to be made, if there's any to be made at all.

Basically, what happens is nothing. There will be months when the index goes down a few percent, or months when the index goes up a few percent. Only when you look back retrospectively will you realize there just wasn't a lot happening. That might be the environment we're in. It's a really horrendous environment, because most people don't have the faculty to be eclectic or to be contrarian.

To put it another way, if we opened ourselves up to the world, there would be a limited number of people we could invite in, because we have a limited number of ideas. It might end up being a golden age for the active manager. In that scenario, the problem for the active manager will not be raising assets; the problem will be turning away assets because you just won't be able to serve very many people. You'll have a set of investments that you have a lot of expertise in, and you'll already own a big percentage of those investments, and very few people are going to be able to duplicate your returns.

Steven Bregman – President & Chief Financial Officer

It could be a 0% management fee and 20% incentive fee world for those managers.

Murray Stahl – Chairman & Chief Executive Officer

Yes, it could be a 0% and 20% world. That's what we charge now for our specialty strategies: the everyday low price of 0% and 20%. Managers would just charge 20% of the profits.

I hope that gives you an idea of what we're working on. We're not merely gathering assets; we're being faithful to our credo, which is contrarian eclectic investments—avoiding the crowd because, as you can see, the crowd has problems.

We don't want to grow vertically in the sense of piling on ever more assets under management in the face of a limited number of ideas. We want to grow horizontally, meaning there will be a set of ideas. It might be a particular bond fund, which has a certain capacity of X, whatever that number happens to be. When we approach that capacity, we move on to the next set of ideas. They might revolve around an entirely different type of investment. You're seeing some of that happening right here in HK Hard Assets, which is separate and distinct from the sum of what we've done historically.

I hope that gives you a sense of what's going to happen in indexation. I don't think there's going to be a day when everything is righted. We might be living with a generation or two during which basically nothing is righted, except for the odd stock here or there.

Steven Bregman – President & Chief Financial Officer

But investors can't see it at the moment, because it's like the fog of war, plus all this natural pattern spotting in which we engage. You turn on the radio in the morning, and the commentators talk about seeing a pattern that certain industry groups have been moving up strongly lately, and then you have a few people who offer a few interesting words about that. It always seems as if something is going on. But if you don't have the training or the expertise to step back and understand structurally what's really at work, years can go by, decades can go by, before you realize nothing is happening.

Murray Stahl – Chairman & Chief Executive Officer

Another point worth noting about indexation is that the fees are collapsing. Many indexes are down to three basis points. The ETF sponsors can raise trillions of dollars in assets under management, but to what end? There will always be expenses. It's not going to serve the clients well, and it's not even going to serve the orchestrators of the indexes well. It's a big problem. The whole system is becoming too problematic. We're very happy to be away from that area.

There will be a role for indexation, but it's not going to be smart beta. It's going to be a completely different kind of indexation, which I would tell you about but I'm in the process of writing about it.

Question 3

In your search for optionality, would you talk about the opportunity set in the global context? FRMO's assets are mostly U.S.-centric, and I wonder if you are seeing excellent opportunities overseas. Please comment.

Murray Stahl – Chairman & Chief Executive Officer

As part of going back to our roots, we are staying within our own circle of competence, meaning our knowledge base. We never will give you the idea that we're experts on everything. The indexation phenomenon, which has greatly narrowed the opportunity set, is a worldwide phenomenon. It's as true in the Far East as it is in the United States, and as true in the United States as it is in Europe. It's basically true everywhere. So, the opportunity set has narrowed everywhere.

We have better knowledge of the United States than we have of other places. We don't shy away from international investing. Sometimes we have expertise in a particular geographical area and understand the laws that govern that investment. But, more likely than not, we'll have more knowledge of the United States and Canada than we'll have outside of those two countries. Therefore, you're likely to see fewer investments outside of the United States than you are inside the United States and Canada. But I don't want to say we're never going to venture out into those countries. From time to time, we do it, and it'll happen.

The United States and Canada have a market that is much deeper and richer than those of many other countries around the world where the markets tend to be very narrow and, I would argue, even more susceptible to the indexation influence than the United States market. I wouldn't expect to see a tremendous shift in assets outside of the United States.

Then there's the issue of currency. If the United States were the only country printing up all this money, we might be interested in foreign currencies. But the various other countries seem to be vying with the United States for the title of which is going to be the champion currency issuer. It doesn't seem like there's any advantage to owning the other currencies. Their interest rates are even lower than those in the United States. We're leaving that door open, but don't expect to see much in that area.

So, that gives you an overview of what's going on. Obviously, there are projects that we're working on, which hopefully can be shared with you shortly. I think that covers my prepared remarks.

Murray Stahl – Chairman & Chief Executive Officer

We thank you once again for your support, and for paying attention to what we have to say. If there's anything we can do to provide you with more information, to the extent that we are allowed to, we're happy to do it. We want to be as transparent as possible.

I apologize for the way the HK Hard Assets is consolidated. It's all done in the GAAP method. Our goal was to provide more information, not less. In this case, you have to know where to look. If you have any thoughts about other information we can provide, to the degree we can provide it, we'll be happy to do it. Let us know.

We thank you once again, and we'll reprise this in about 90 days for the next quarterly call.

Operator

Ladies and gentlemen, this concludes today's conference call.

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applicable disclosure documents for a complete set of risks, expenses and other pertinent details. Index returns assume that dividends are reinvested and do not include the effect of management fees or expenses. You cannot invest directly in an index.

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