FRMO Corp. Q2 2017 Conference Call

Tuesday, January 19, 2017

Operator

Good day, and welcome to the FRMO Corp. Quarterly 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.

Thérèse Byars – Corporate Secretary

Thank you, Don. Good afternoon, everyone. This is Thérèse Byars speaking, 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 Corp. website at www.frmocorp.com.

Today's discussion will be led by Murray Stahl, Chairman and Chief Executive Officer. He will review key points related to the 2017 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 Murray Stahl.

Murray Stahl – Chairman & Chief Executive Officer

Thanks, Thérèse. Just for reference, normally Steve Bregman is here with me for these calls, but he can't be with us today, so you'll just have to settle for me.

Steve usually starts with the earnings, so I'll do that. You can see what they are. Some people like to look at what's called the consultancy and advisory fees revenue line, which they use to figure out how much the Horizon Kinetics assets under management have grown or declined. As you know from prior calls, we have been emphasizing higher-margin over lower-margin businesses. We're not going to engage in low-margin asset gathering anymore but, instead, we'll concentrate on activities for which we actually get paid.

You can't see it in this quarter's results, because it happens as of the Horizon Kinetics year-end (December 31), but we ended up with performance fees in 2016, in contrast to 2015. I don't mention it so much to highlight the performance fees as to call attention to a couple of things that we're doing structurally in the various funds, which maybe we should have thought of doing a long time ago, but we're doing them now.

First is the nature of—and I hesitate to use this word—hedge funds. We don't like to call any of our products hedge funds but, in this context, we will use that term for lack of a better one. Historically, managers of a hedge fund received something called a short-seller's rebate. In crude terms, let's say someone bought $1 million of equities and sold short $1 million of equities, so they were market-neutral. Let's make believe that we are back in the good old days and interest rates are 10%.

On the $1 million you sold short, you would get roughly 75% of the proceeds invested at the short-term rate, or alternatively stated, you would earn 75% of the interest income collected on the whole short position. If you were a $1 million short, and the proceeds were invested at 10%, and you collected 75% of that, that would be $750,000. And, in relation to $1 million of equity—remember you have $1 million of equity, and $1 million short—you had $75,000 of interest income.

In theory, even if you were a rotten stock-picker, your shorts could have outperformed your longs, and you know what? You actually could have had some very respectable performance. Let's say that as the market went down, your longs went down 10%, and your shorts went down 9%. You lost 10% on the longs, but you made a 9% profit in shorts, so you lost only 1% net. But you had the 7.5% short-seller rebate. So, net you were down 1%; add to that the 7.5% in interest income, and you still had a 6.5% profit when the market was down 10%. You looked like a genius.

Unfortunately for the world of hedge funds, that reality no longer exists, but the industry never really adjusted to that change. They would maintain a certain long ratio and a certain short ratio. It wasn't necessarily one-to-one as in the example I just mentioned, but they would have a certain ratio. But in today's interest rate world, instead of collecting the rebate, they now have to pay money on just about anything shorted. Let's just say you are short a security that isn't part of the S&P 100, or even if it is part of the S&P 100, you would pay something to borrow the shares. If that security yields 2.5%, you have to make good that 2.5% dividend. Even if they charge you only 1% or 1.25%, that's almost 4%.

So, nowadays, if you manage a market-neutral strategy, and you have $1 million long and $1 million short, you're already down not far from 4% on the borrow and carry costs on the short side of the book, upon which, if you charge a 1% management and 20% performance fee, the portfolio starts off negative 5% instead of plus 7.5%.

That's essentially the problem with a hedge fund. And it's essentially a problem with every partnership. (As I said, I don't like to call them hedge funds.) What we at Horizon Kinetics needed to do—and I'm sorry it took a long time for me to realize this—we needed to focus our short-sale attention the way we do in FRMO on the balance sheet, which we're going to come to in a few minutes. We needed to focus on the short positions that are path-dependent, where we could reasonably forecast—though without knowing for certain—that we were going to get a positive rate of return on our shorts. So, we concentrated on the path-dependent securities.

If we're getting a positive rate of return on our shorts, and assuming we have reasonably good stock selection, then we're getting a positive return on longs, now we've returned to the historical circumstance. That's what we needed to do. We needed to realize that the idea of being long X number of securities, bolting on some shorts, and paying the associated costs was not going to work for anyone. That's actually a sea change. I wrote about this subject in our research. We'll see how many people emulate us. I have a feeling not very many will.

Another point that we should have realized is that when we used options for hedging purposes, or even options to take a position, we really never looked at it from the prime brokerage standpoint, meaning how the prime broker would look at our option positions. Let's say you want to hedge a short position, whatever it is. Even if the short is path-dependent, it can go up, which means a mark-to-market loss, even if temporary. For the sake of argument, let's say you sold short a path dependent security that is trading at $9 and that you wanted to hedge, but didn't want to risk the position going up too much. You would buy a call option on that security, and you'd set a range of strikes at higher prices, say $10, $20, $30, $40, $50, et cetera.

Ignoring the questions of what it costs to do this, you would think, all things being equal, you're better off where you have less risk, such as buying, say, one option at a $10 strike rather than buying more contracts at a $20 strike. It turns out, though, that the notional exposure you have actually makes a really big difference to the prime broker for their marginability requirements. We never really focused on that the way we should have.

Basically, we weren't using our option dollars as hedges for the maximum result, but now I think we're doing a lot better on both of those counts. We're using the option dollars, to the extent we have them, though it's not a big part of our funds. Hedging can be very expensive because you expect to lose money on the hedges. To the extent you can invest less money and have a lot more exposure, it's a good thing, not a bad thing; it helps your performance. On that and the path-dependent securities as well, we did a lot better and have had a lot better results. That's actually important.

It's difficult but important to stay true to our contrarian/value-based principles, which means always buying out of favor. Historically, we did that. The only problem is, when the market is at an all-time high, it becomes more difficult to accomplish. Therefore, we needed to be more selective. When you're more selective, you have fewer names and, you could argue, you have less diversification. But you have more margin of safety, so it's a balance. How much diversification do you really need, and how much do you require when the price of greater diversification is giving up a certain amount of margin of safety? And I think we do a better job on that account. We're going to have, at least in the next quarter, a favorable experience.

Turning to the balance sheet, you'll see our cash position is still almost, but not quite, $50 million, which is a function of the lack of investment opportunities. That's as it should be. With the market at an all-time high, we should see fewer, not more, opportunities, both on the fixed income side and on the equity side. One day, that will change. I have no idea what day that will be, but I suspect one day it's going to change.

On the short side, you can see the purchase price of our shorts, what we carry them for at market, and from which we continue to make a certain sum. In the good old days of FRMO, we just kept carrying these positions in path dependent securities on and on, and never covered them, so you could readily compare the original cost and current value to see the full return. But now, in some instances, because we've begun to use options in some of these positions, we've been forced to cover them or they would have expired, and we generated a profit. You can no longer look at these items to figure out what we've actually made over the years on options. But rest assured it's more than previously.

In the month of January—actually, in a couple days—we'll be realizing more profits, not because we want to realize the profits, but because these were options that were sold short, generating proceeds at the moment of sale, but will be expiring worthless. That's just the way it works. We'll pay whatever the tax is but, of course, they have already been accrued, so paying them won't change the net asset value. We're looking for more interesting shorts, and we are finding them. On the short side, there are some interesting approaches, particularly among the path-dependent ETFs.

That's a brief synopsis of what we are doing. Normally I'd go into more detail, but there are a few questions here that actually cover points I wanted to raise. I thought the questions were particularly apt.

Question 1

The investments in OneChicago, Digital Currency Group, CNSX, Miami International, and National Stock Exchange Holdings represent slightly more than $1 million in FRMO assets. These seem almost individually immaterial next to the $2.7 million investment in the Bermuda Stock Exchange. Given it takes managerial attention to monitor all these investments, are they significant enough in size to move the needle? Or is the thinking that they provide access to an asset class with upside optionality, and a little gives sufficient exposure?

Murray Stahl – Chairman & Chief Executive Officer

Well, maybe the fair answer is: neither. Each of these exchanges has a unique set of licenses, not merely an exposure to a certain asset class, although that's important as well. The optionality part of it would be great if it materializes, and I hope it does.

In the meantime, the exchange investments do offer a certain amount of optionality. As far as the listed exchanges, I'll just give you a little news update on some of them. The National Stock Exchange (NSX) is being bought out by the Intercontinental Exchange (ICE). That transaction is very interesting. As we understand it, a number of shareholders were obligated to keep funding the company, and this transaction frees them of that obligation. From their standpoint, perhaps that's a positive outcome. I guess the NSX employees will become the employees of ICE. So, perhaps from the employees' point of view, having less sacrifice in their lives is maybe a positive as well.

From FRMO's point of view, we had neither obligation. We were neither employees, nor were we obligated to keep funding them. We were just shareholders. We'll find out what happens but, at the moment anyway, we're not obligated to sell. We'll find out whether or not that provides any optionality.

To speak more tangibly about optionality, I'll read an excerpt from a press release about the Bermuda Stock Exchange (BSX), dated January 11, 2017.[1]

> The volume of insurance-linked listings of catastrophe bonds, insurance-linked securities (ILS), reinsurance sidecar notes, and insurance-linked investment funds on the Bermuda Stock Exchange reached a new high at the end of 2016, exceeding $20 billion for the first time.
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> A record 61 new ILS listings listed on BSX during 2016, with a combined capitalization of $6.157 billion, which took the total number of ILS listings on the exchange to 175, growth of 16%, reports the BSX.
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> In total, says the BSX, 175 listings on the exchange at year-end 2016 had a value of $21.22 billion, up 10% from the $19.21 billion reported a year earlier, making it a new record for ILS listings on the exchange.

Obviously, that asset class is flourishing. We talk about it from time to time, because we have high hopes for it. This is really the issue with exchanges. It's not so much that Bermuda managed to accomplish these results, although it's no small accomplishment; it's that, if you look at the big exchanges in the world, and you look at the assets that are listed on them, you will see that there's a lot of correlation.

In some cases, they're national exchanges and, on any given day, if one is down, they're all down. You could say the same about the bond markets, because they're all correlated to interest rates, and interest rates are very low everywhere in the world; they're correlated, too. In some cases,

[1] http://www.artemis.bm/blog/2017/01/11/ils-listings-on-bermuda-bsx-reach-record-high-of-21-2bn/

interest rates are even negative. Even currencies trade off of interest rates. So, there's a great need for uncorrelated assets.

What you see on FRMO's balance sheet is a list of investments that have those properties—they have uncorrelated assets. For example, OneChicago is where one can trade single-stock futures. There are a lot of possibilities with single-stock futures. I encourage you to go to the website of OneChicago to see what the volume is and how that exchange has been flourishing recently. Single-stock futures open up a lot of opportunities in terms of posting collateral and other activities that you really can't accomplish with other instrumentalities.

Anyway, that's a long-winded way of saying that, hopefully, the sum of the parts will prove to be greater than the whole. But even if they aren't, some interesting things are happening on the exchanges. They're strategic as well as quantitative investments for us.

It's not so much the management of the time of following them; it's the management of the time of learning about new asset classes. It's not merely a question of applying our existing knowledge to finding new investments, which we do, but the thrust of it is there are whole new asset classes starting. If you accept that proposition as legitimate then, obviously, when an asset class is brand new, we won't already have superior knowledge of it. We'll have little, if any, knowledge, and we'll have to learn. For us, exposure to these investments is not merely an exercise in analytics; it's also an education in and of itself. That's the role they play.

Question 2

I'm a little bit perplexed by the focus on bitcoin. Isn't it primarily for drug dealers and libertarian nuts?

Murray Stahl – Chairman & Chief Executive Officer

To begin with, let me say, that in regard to the categorization of drug dealers and libertarian nuts, we believe ourselves to be neither.

What's the logic of bitcoin? You can see it in FRMO's investment in the Digital Currency Group. Bye the bye, what you can't see in our financial statements is that we have classes of a fund at Horizon Kinetics dedicated to bitcoin. We're actually investing in it. So, let's talk about bitcoin, and let's talk about its emergence as an asset class. What's more important, to be germane to the question, what is it, why do we have an interest in it, and really, why is it not a haven for drug dealers and libertarian nuts?

The first problem, which I mentioned earlier, is the issue of the correlations. Historically, in the national markets, bonds, stocks, and currencies were uncorrelated. They were uncorrelated because, historically, different nations promulgated different monetary and fiscal policies. Today, however, as anyone can plainly see, they all engage in more or less the same monetary policy. I make reference to the Federal Reserve, the European Central Bank, the Bank of Japan, and others. In terms of lowering interest rates, in terms of quantitative easing, their actions are about as aggressive as they've ever been in history. Give or take stylistic differences, they're all pretty much the same, which is one of the reasons why securities have become so correlated with each other.

The second problem is that most nations would like to stimulate their economies by having their currency lose part of its value, thereby making their exports more attractive to customer nations. That may or may not be a sensible policy; I'm no judge, because I'm no expert in central banking. But, whatever the country happens to be, if you're going to use money as a store of wealth, these are actually pretty bad policies, because your money is going to lose value.

If you look through a book such as the Ibbotson study, *Stocks, Bonds, Bills, and Inflation (SBBI)*, you would see that historically this policy was not as big a problem as you might think it would be. In a security such as T-bills, yes, the dollar did lose 90%-plus of its value over the course of a century. Of course it did. But that's why you received an interest rate on T-bills. With some brief exceptions, including World War II and its aftermath, and in the last five years or so, the interest paid was enough to provide a real rate of return, even allowing for the negative real rate of return in the two periods I mentioned.

Today, you get essentially nothing. It's not quite nothing, but it's almost nothing. It's a guaranteed negative real rate of return. Somebody has to own the money, but leaving money in cash is a guaranteed losing proposition.

What would people prefer? Since you can't really do much to change the central bank policy, you will see the emergence of cryptocurrencies, of which bitcoin is only one but, so far, it is the major one. The logic of bitcoin is that it's a noninflationary store of value. There's a technology called blockchain, which is a really sophisticated technology, but it's open source, meaning anybody who wants to have a blockchain can have access to the code, and adapt it however they choose. The code is not secret or patented. It might be a very good thing, and it might be a very brilliant and ingenious investment, but anybody who thinks blockchain is something that's utilizable can get it.

The point of any cryptocurrency—and, as I said, bitcoin is the leader—is the issue of value. At the moment, there are roughly 16.1 million of them, and there will never be more than 21 million, a number that will be achieved in the year 2141. (According to Blockchain.info, the actual number at this time is 16,110,713.) The current price of one bitcoin is $899.17. For purposes of discussion, let's round it to $900. Let's multiply $900 by 16.1 million units to get $14.49 billion, the aggregate bitcoin market value.

Let's assume, arguendo, as they say, that more than merely libertarian nuts and drug dealers get involved in bitcoin, and they assume it to be a legitimate store of value as a transactional medium. For any country, even for a very small one, $14 billion, $15 billion, or even $16 billion is nothing.

In the context of the United States economy, the current value of bitcoin is not even worth recording. As a matter of fact, just to give you an idea, I believe, if I'm not mistaken, that all the gold in the world today is probably worth over $7 trillion. Imagine if the value of all the bitcoins were not $14 billion or $15 billion, but were just worth the same as all the gold in the world.

What if it were? You can pick a number. Let's assume that it's being used as a store of value. What should it be worth? Obviously, I don't think it's going to be worth $14 billion to $15 billion. What could it be worth? I don't know the answer; I'm just offering possibilities. Could it be worth the value of all the gold in the world, which is roughly $7 trillion? Possibly. Could it be worth all the gold and silver in the world? That would be a larger number. You can calculate what the coefficient of expansion would be, which is how many times your money you would make.

Could it be worth what the money supply is worth? If so, would that be the value of just the dollar, or is it the value of the dollar plus the euro? Is it the value of the dollar plus the euro plus the yen? Is it the value of the dollar plus the euro plus the yen plus the Swiss franc plus the Mexican peso plus the Brazilian real plus the pound sterling plus the Chinese yuan? You get the idea. What could it be? It could be a huge number. We don't know the answer. It's just that it's the greatest optionality we've ever seen in relation to a concern that people should have. You can't let your store of value get inflated.

By the way, it doesn't just apply to cash, because there are nations in which the bonds, even 10-year bonds, basically yield nothing. In any event, whether they yield something or nothing, they clearly have a negative real rate of return. Even if the German bund yields, I don't know, 20-some-odd basis points for a 10-year, whatever that number is, factor in 2%, 2.5%, or 3% inflation, whatever it's going to be, and it's clearly a negative rate of return in real terms.

That's the idea. If you raised a little money, which we did, and if the coefficient expansion is anything like what it could be, that will be a very, very big return. What we tell people is—and everyone's had this experience—you go on vacation. You spend X thousands of dollars. You really shouldn't have gone, because the plane was horrible, the food was horrible, the hotel was horrible, the service was horrible, the weather was horrible. Everything was horrible, and you just wasted your money, and you have nothing to show for it. Nearly everyone has had that experience, so I say to take an amount of money equivalent to that sum of money that you would have spent on that terrible vacation, or a little bit less if you prefer, or even a lot less if you prefer, and put that sum into bitcoin.

I'll address the investment in Digital Currency Group more seriously in a minute. But, for your edification, if you wish, you can go to a website called Blockchain.info, which is a blockchain explorer. The blockchain is where all the bitcoin transactions happen. If you go to the Blockchain.info website, you'll see across the top a number of tabs you can click on. If you click on Charts, and scroll all the way to the bottom, you'll see the number of Blockchain wallet users.

Click on that and you'll see that the graph looks like a graph of Facebook users in terms of the slope of the line. As of not that many minutes ago, there were 11,379,296 Blockchain wallet users.

Blockchain is one of the most popular wallet providers, and I believe that those are about half of all the bitcoin wallets in existence; if so, there are roughly 22 million bitcoin wallets in existence. But whether the real number is 22 million or 11 million, bear in mind that there are 16,107,000 bitcoins, and the 11,379,296 number of Blockchain wallets increases by roughly 24,000 a day. So, if you believe in the law of supply and demand, there are either 11,379,296 drug dealers and libertarian nuts in the world, which might be a low estimate or, if the number of people who are outside of those two avocations and who use bitcoin as a store of value is growing, then we might see that number begin to outpace the total number of libertarian nuts and drug dealers. If we do, that's a big deal.

You have no doubt read about the Indian demonetization and seen how its citizenry didn't like it. And no doubt you've read about the Venezuelan demonetization, and how people didn't like that too much either. How do governments escape from their obligations? Historically, it's through some type of inflation, which has been described as default without defaulting.

Digital Currency Group is the company that operates the Bitcoin Investment Trust (GBTC), through a company they control called Grayscale. They also make various venture capital investments in bitcoin-related or blockchain-related technology. It doesn't have to be related to bitcoin or to the bitcoin blockchain itself. It's not even entirely clear that bitcoin will emerge as the dominant currency in the cryptocurrency world. It might not. But, at the moment, it happens to have the lead and, in the world of trading, the first mover advantage counts for a lot. It's extraordinarily difficult to overcome the first mover advantage.

That's the reason for our focus on bitcoin, although, obviously, as you can see from our balance sheet, we're not going to put the bulk of our assets in bitcoin or bitcoin-related investments. Just bear in mind that if the coefficient expansion is anything even remotely close to what I alluded to, even a small investment can be a very, very big deal.

Question 3

Have you looked at the financial technology company t0.com, Inc. as an exchange investment?

Murray Stahl – Chairman & Chief Executive Officer

I don't know a lot about it, but it uses blockchain technology, so I'm interested in it. It's designed to have zero-day settlement, which is why they call it t0, as opposed to t-plus-3, as we have right now.

Among other things, blockchain technology could change not just the whole nature of securities processing, but it could change the whole nature of how retailing is done, how payments are made. It could change the manner in which governments are able to intervene in financial markets because, in the last 100-or-so-odd years, the central banks have become dominant. Just look at the balance sheet of the European Central Bank, or the Federal Reserve, or the Bank of Japan, and you can see how much they've expanded their balance sheets in recent years. You can see how much money it is in relation to the economy. That's going to have an impact. We can debate what the impact is, but it's openly stated, so it's no secret that their policies are designed to cause a certain amount of inflation. Maybe they can calculate exactly what it is and hit that number, and maybe they can't. I leave it to minds better than my own to figure out whether that happens or not.

Basically, it all comes down to the fact that the number of ways you can create new financial products is rapidly expanding as a consequence of the blockchain. For example, there's a unit of bitcoin called a satoshi, which is one hundred-millionth of a bitcoin, if you can believe that. Because every satoshi will have a unique identifier, in theory, you could attach a satoshi to every single share of stock listed on the New York Stock Exchange. Maybe t0 has figured out how to execute same-day settlement. Or, if the technology were to progress, you might even have virtually instantaneous settlement, meaning settlement in 10 minutes. That could really happen.

What role will exchanges play? What role will custodian banks have? Will you need custodian banks? Can you have naked access, which is something that regulators have never allowed? The answer is unclear, but the world is changing incredibly rapidly.

If you're interested in financial services, if you're interested in transactions, if you're interested in Visa and MasterCard, think about what a retailer pays Visa, MasterCard, and American Express for allowing people to pay for goods and services using a card. Imagine if Walmart didn't have to pay them. What percent of Walmart customers do you think use some type of plastic? The answer is a very large percentage of them. Walmart is not a high-margin business. Imagine if they could eliminate some or maybe even all of that charge. What would happen to Walmart's margins? They would be a lot higher. You're talking about tremendous amounts of money.

All of this and much more is possible via the blockchain. But, as I said, it may or may not be bitcoin but, at the moment, it has the lead. It's a whole world out there. We would be remiss if we didn't study it very carefully, and that's what we're doing. As you can see, we have a little bit of capital invested in it. We'll see if it's successful or not.

That concludes the questions I received for this call, and I thank you for them. As you probably have surmised, we try to tailor the discussion to the tenor of the questions we get. So, please submit more. Whatever your issues or concerns or areas of curiosity are, we will direct our presentation to those matters.

Thank you once again for listening to us and giving us an opportunity to tell you what we're doing. I look forward to reprising this presentation in about 90 days. Keep those questions coming in.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you for your participation.

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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