

FRMO Corp. Q2 2018 Conference Call
Tuesday, January 16, 2018

Operator

Good day and welcome to the FRMO 2018 Second Quarter Conference Call. As a reminder, today's call is being recorded. At this time, I would like to turn the conference over to Thérèse Byars. Please go ahead, ma'am.

Thérèse Byars – Corporate Secretary

Thank you, Kevin. 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, and Steven Bregman, President and Chief Financial Officer. They will review key points related to the 2018 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 Mr. Stahl.

Murray Stahl – Chairman & Chief Executive Officer

Thank you, Therese, and thank you all for joining us. I thought what I'd do today is take you on a little balance sheet tour, because that will give you a sense of what we're thinking about, our assets and the direction we're going in. I'll make some strategic remarks related to that, then I'll answer the questions that were sent to us, of which we have quite a few.

Let's begin with the balance sheet. As you can see, we had \$52 million of cash and equivalents at the end of November 2017. If I'm not mistaken, that's the highest amount of cash we've ever had. If you look down the balance sheet, in terms of categories of assets, cash by far is the largest.

That should give you an idea of what we're thinking because, in general, financial assets are at the highest levels they've been. I don't believe I'm mistaken in saying that valuations are at the highest they've ever been since records of them began to be kept. I don't know if these will remain the highest on record, because they could even go higher,

FRMO Corp. Q2 2018 Conference Call
Tuesday, January 16, 2018

but I think we should recognize that they're at unprecedented heights. Usually, when they reach unprecedented heights, they come back to something more normal. There's no guarantee that will happen, but that's usually what happens.

A new item on this balance sheet is one that I spoke about last time but it wasn't yet on the balance sheet. It is called "Fixed Assets" and is in the amount of \$64,000 and change. That is our cryptocurrency mining equipment—that's real computer equipment with which we are mining cryptocurrency. If you look farther down on the balance sheet on the third line from the bottom of the Assets section, you'll see the \$68,000 investment in HK Cryptocurrency Mining LLC. Let me describe those two items.

HK Cryptocurrency Mining LLC is actually engaged in cryptocurrency mining. It sells the currency it mines more or less as fast as it comes in and converts it into U.S. dollars, which is fiat currency. In its entirety, HK Cryptocurrency Mining LLC has about \$4.7 million of assets. Horizon Kinetics (HK) itself is a much larger investor in the mining entity than FRMO. This LLC will pay a dividend in about a week, give or take a day or so. I have a pretty good idea of what that dividend will be, but I'll wait until we have the exact number. Then I'll be able to provide the market value of the cryptocurrency we have mined since we started. We began mining on a certain day in September, and I know how many coins the LLC has today, but I didn't keep a record of how many coins we had on November 30. In any event, we'll have that number for the next call. You'll see, in both cases that they're very robust returns. Obviously, these are very minor assets. More about that later.

On the last call, I noted that the exchange investments would be collapsed into one line, with the details included in the notes, and that has been done.

FRMO's investments in the HK funds have appreciated significantly. I'll ask you to take particular note of the investment in Horizon Kinetics Hard Assets LLC, which you'll find in Note 1. It's important to note that the market values of the funds are as of September 30. Even though this is FRMO's November 30 balance sheet, we use the September 30 numbers for the funds. But the cash on the balance sheet is as of November 30.

It's important to note that the fair market value of HK Hard Assets (as explained Note 1), was more than \$1.8 million. Although it says "as of November 30," that's actually the fair market value as of September 30. It's just that we're using the September 30 value for November 30 purposes. And the same holds true for the other funds as well.

I note these amounts to highlight the proportion of the cryptocurrency investments in relation to FRMO's other investments. Even if you add the two cryptocurrency investments, the total is only about \$130,000 while the HK Hard Assets investment is \$1.8 million. That difference in magnitude tells you that we're not throwing tremendous sums of money in cryptocurrency, even though we think we can get a very high return on them, because—and we'll come to more of this later—it's possible that the whole cryptocurrency project could be a failure. If it turned out to be a failure, we would live to fight another day.

FRMO Corp. Q2 2018 Conference Call
Tuesday, January 16, 2018

On the last conference call, I said I would provide an estimate of the market value of FRMO's cryptocurrency assets on the balance sheet and on a look through basis. As of the most recent reckoning, which is as of a few weeks ago, the market value of the cryptocurrency assets in the funds, and the small amount that we have that is not in the funds, was about \$12.4 million, give or take. We'll keep giving you that number.

If you think about the number, and you want to make use of it, it's important to consider that there's a fair amount of income tax as of November 30 that's due on the appreciation for all of our investments. We made a very small initial investment in the cryptocurrencies—less than \$1 million. You'll see on the liability side of the balance sheet about \$10.8 million of taxes due. That's a lot of money.

If you really want to keep track of our cryptocurrency assets, first understand that if the cryptocurrency assets decline by 10%, our net asset value would not decline by 10%, because you have to back out some taxes on the unrealized gains. Second, this balance sheet was prepared before the new tax bill came into effect. Even though we knew the tax bill had passed or was about to pass when we prepared this, it wasn't in effect as of November 30. Therefore, if today were February 28, and everything were held constant, the deferred tax liability of \$10.8 million would be different. Assuming all things are equal—and, as you know, they're never equal—but assuming they were, just for the fun of saying it, I believe the deferred tax liability would be about \$3.9 million lower, and our equity would be \$3.9 million higher, which is a considerable amount of money.

Steven Bregman – President & Chief Financial Officer

There's another tax issue that should appear in the next quarterly release, which is that our income taxes payable will show a reversal because, as a deferred tax liability goes down, instead of a negative number for income taxes, we should get a positive number for income taxes. It will be a temporary occurrence, but it'll increase the stated income for that quarter.

Murray Stahl – Chairman & Chief Executive Officer

Right. We think cryptocurrency has a bright future, but by no stretch of the imagination do we want anybody to believe we're turning this into the FRMO Cryptocurrency Corporation. For those who wish to trade our stock based on the gyrations of cryptocurrencies, please bear that in mind. I think it's a piece of information that you probably should have.

We're working to get away from conventional investing, first, because the fees are very low, largely because of indexation. Second, and much more importantly, the opportunity set is constrained. With the markets at their highest valuations in history, we're looking for other types of investments. Even though we'll be involved in cryptocurrency, you will see other investments in the not too distant future, assuming they work out.

FRMO Corp. Q2 2018 Conference Call
Tuesday, January 16, 2018

The basic idea is that we want to invest in assets that are not correlated with conventional indexes. These investments are not sufficiently liquid to allow expansive use by a wide variety of institutions, but they are sufficiently liquid for us to use very safely, along with our clients and perhaps some other investors as well. The next item you're likely to see from us will probably involve natural resources that are different and distinct from the HK Hard Assets portfolio. It will involve short selling. I won't bore you with that right now, but that's the next project.

So, I want to dispel any notion that we're putting all our eggs in a cryptocurrency basket. That said, I think cryptocurrency has a bright future. We'll cover it more as we answer the questions.

Question 1

Regarding the RENN Fund (RCG), please discuss the cash levels, net operating losses, management fees, and assets under management. Do you plan on engaging in a rights offering to boost assets? In your opinion, is there a shortage of good investment ideas out there? Why do you think RCG is now selling at a 4% to 5% premium to NAV when historically the fund has sold at a substantial discount? Over the long term, will RCG look like the Kinetics Market Opportunities Fund or another Kinetics fund?

Murray Stahl – Chairman & Chief Executive Officer

There are a lot of questions there. I'll begin with the cash level, which is over 30% of the fund's net assets.¹ The net operating loss carry-forwards are over \$23 million, which is substantial relative to net assets of just under \$7 million. At the moment, believe it or not, the management fee is zero, and it's going to stay zero until we get over \$25 million in assets.

Regarding the question of a possible rights offering, we'll have to do something to boost assets, because we're not going to have a fund with a zero management fee forever. Something will happen and, when it does, we'll make a public announcement.

My answer is yes to the question of whether there is a shortage of good investment ideas. There are all sorts of actions you want to take to protect yourself when there are only a few good investment ideas out there. Basically, the opportunity set is very narrow, but that doesn't mean there's nothing out there. You have to be cognizant that there's not a lot of great stuff out there; however, the few that are out there might actually be pretty darn good, and we might have to run the portfolio with a more narrow focus than we would have historically.

¹ As of September 30, 2017

FRMO Corp. Q2 2018 Conference Call
Tuesday, January 16, 2018

In answer to the question asking whether the RENN Fund will end up looking like the Kinetics Market Opportunities Fund or another Kinetics fund, the answer to both is no. It will look different from the other funds. By no stretch of the imagination will it be a clone of the Kinetics Market Opportunities Fund, nor will it be a clone of any other Kinetics fund.

On the question of why the RENN Fund is now selling at a 4% to 5% premium to NAV, when historically it has sold at a substantial discount, well, that's hard to answer. The honest answer is that I don't really know with specificity, but even if I knew with specificity, I wouldn't be allowed to answer the question. I have some conjectures, but they're nothing other than conjectures. To answer that question would just mislead people, and I might be wrong in any event. So, if you don't mind, because of the position I'm in, I'll have to punt that one.

I'm going to get a little expansive for a minute, because I promised you some strategic comments. For at least the last three-plus decades, maybe 35 years, all of us in the investment management business have been lucky, and we've all gotten lazy. Why have we been lucky and become lazy? Don't forget, in the early 1980s, interest rates were in the double-digits. The interest rate declines from that level to the current level raised the valuation of just about every financial asset you could imagine.

The evolution from double-digits to where we are today is without any historical precedent whatsoever. Everybody who was investing in financial assets made money; whether you beat an index or not, everybody made a very robust rate of return. But those days are over. I am not asserting whatsoever that interest rates are going up. I am asserting that as far as help from the world of interest rates goes, this is basically it.

We need to get used to the fact that we're not going to have artificial valuation increases of that type, even though central banks around the world, like the Swiss National Bank or the Bank of Japan, buy equities. I guess they're substituting. There is also vigorous buying from the index world. That buying can only help valuations. There are other factors that help valuations, and that's why we're in this predicament of having the highest valuations of all time. We really have to be cognizant of it.

Question 2

In the current economic environment, what does the company plan to do to find more substantial and consistent earnings streams?

Murray Stahl – Chairman & Chief Executive Officer

We'll look for more niche asset opportunities and hope they're exploitable and that we find something different every few months. At the moment, we're working on instruments to be

FRMO Corp. Q2 2018 Conference Call
Tuesday, January 16, 2018

short in the world of natural resources, and it has an indexation flavor to it. We'll be on the short side of indexation. I think it will be very interesting to people.

The reason for choosing that sector—apart from the fact that it appears to be a good investment opportunity, whatever its ultimate merits or lack thereof—is that it's different from conventional equities, it's different from conventional bonds, and it has nothing whatsoever to do with cryptocurrency. Ideally, we'd like to have a variety of unique assets, so that every quarter one investment vector or another would be working and producing a performance fee. That's the basic idea.

Question 3

In the current economic environment, what do you believe it will take for the prices of assets to offer better risk/reward tradeoffs?

Murray Stahl – Chairman & Chief Executive Officer

The easy answer is that it could all go down 30%, 40%, or some sufficiently significant magnitude, because it would then obviously offer a much better trade-off. But I don't believe that will happen—not that it shouldn't happen. I could be very wrong but, looking at the flows into indexation assets at the moment and, much more importantly, looking at the actions of the Bank of Japan, the Swiss National Bank and our own Federal Reserve in transacting in the VIX Index and many other securities, there are considerable forces at work that would like to preserve these asset valuation levels. They have at their disposal incredible sums of money, truly mind-boggling sums of money. So, to say that situation will alter, I would need a reason for saying how and why it will alter. That said, it might alter. I just don't see what the catalyst is, although maybe there is a catalyst.

Question 4

What are the Company's investment parameters for commodity deals? What differentiated insight and information network does the Company have to find, and create value from (private) income generative precious metals and oil & gas assets?

Murray Stahl – Chairman & Chief Executive Officer

We don't know about gold mines, silver mines, oil wells, or anything similar that a lot of other people don't know about. We have no unique insight into deals. We don't have any meaningful private network for information. We don't have any of that stuff.

What we do have is what I'll call “differentiated insight.” There are all sorts of securities that have unique properties that for one reason or another reason don't qualify for index inclusion. They have features that make them statistical outliers. That's our opportunity set. I can't say there are hundreds of such securities, but I can say there are dozens of them.

FRMO Corp. Q2 2018 Conference Call
Tuesday, January 16, 2018

They are both individual securities and indexes. In the index case, because of the constraints of the index requirement to be homogeneous over time, as a practical matter, it forces the index to buy high and sell low.

I can give you concrete examples, which I do sometimes in my speeches. But I hesitate to do it right now, because we might actually do something with some of those securities, so I would prefer not to name them. But those who attend my public appearances can probably have a good guess of what some of those interests are.

As I said, they have nothing to do with conventional securities. They don't even have much to do with the underlying commodities themselves, because the indexes can produce unintended rates of return due to their path-dependent properties, even if the commodity doesn't work in your favor. Phrased alternatively, if the commodity doesn't go in your direction, the path-dependent properties will go in your direction, and you will have a margin of safety.

Although I'd like to believe that we have some unique insight into commodities, it's just that commodities are the most contrarian of all the assets, and we happen to be contrarian; therefore, we've spent a certain amount of time studying that group. Hopefully, from the point of view of the world, there won't be very many contrarian assets for us to focus on. While that would be bad for us, it would be good for the rest of the world. But I have a gut feeling that there will be a lot of contrarian assets. That might be very bad for the world, but it might be very good for us. I wish the world good, not ill so, frankly, I would rather have fewer opportunities and higher valuations for everybody else. I just don't think it's going to end that way. But that's just one person's point of view.

Question 5

What would cause you to change from a buyer to a seller of crypto-related assets? What is your response to the latest comments on crypto-currencies from Warren Buffett and Charlie Munger?

Murray Stahl – Chairman & Chief Executive Officer

I'll answer the second part first, because it's easier. I don't have a response to Warren Buffett and Charlie Munger except to say I'm almost in complete agreement with them. Most of these cryptocurrency assets will not have a very substantial value, if they have a value at all. So, they're not wrong.

Let me explain what goes on in the world of cryptocurrencies in much more detail. It's not a degree of detail that they went into, and I don't know what their thinking is on cryptocurrencies. I'll just talk about my thinking.

FRMO Corp. Q2 2018 Conference Call
Tuesday, January 16, 2018

In general, to have a successful cryptocurrency you need a number of elements. I'll touch on three of them. The first is that it must have a sound monetary policy, meaning very little inflation. From that point of view, it's no different from a central bank. If a cryptocurrency issues 15% more supply each year, then sooner or later it will affect the cryptocurrency valuation, no matter how interesting its attributes and technical features, no matter how fast it is, no matter its facility with smart contracts, no matter its other attributes. Sooner or later, and probably sooner, inflation will catch up with it because, at the end of the day, it won't be a proper store of value.

Second, a cryptocurrency is not merely a coin; it's an operating system and a distributed ledger. As a distributed ledger, the operating costs are borne by the people who operate it. Therefore, it is incumbent upon the people who design the cryptocurrency to give the operators of the currency itself—or I should say the distributed ledger, or the blockchain, more properly speaking—they need to give them an incentive to operate the system. There has to be a payment.

Third, in addition to the payment, there must be a disincentive to do something improper—not merely an impediment but an actual disincentive. Let's talk about the disincentive first, then we'll look at the incentive to operate the system, then we'll talk about the monetary policy, because it's the easiest.

If you're mining bitcoin, you're making a very substantial investment in fixed assets. If you were to do something to endanger the integrity of the system in any way, you could well destroy the cryptocurrency itself. Not only would you destroy the value of any cryptocurrency you maintain in inventory, you would also destroy the value of all your equipment, because no one will want to use that cryptocurrency or the mining equipment.

Bitcoin was designed that way. Whoever this fellow Satoshi was—or perhaps it was a group of people—who designed it, a lot of thought went into it. The bitcoin protocol is what's called an organic system, which is an important point, so I'll dwell on it. In organic systems, the people who operate it develop their own conventions and incentives. The likely result is equilibrium over the long term, because the system itself is solving a need. The people who operate the system are solving a need, and they have skin in the game, so to speak. They're risking a very substantial investment in equipment. This type of system is referred to as proof of work.

The HK Cryptocurrency Mining LLC will have \$4.7 million of equipment when it's fully invested, and it will eventually have more. That's a big investment. Theoretically, we might be able to do something to impugn the integrity of the system, but to what end? We have to be able to take out a lot more than we put in, so we would be giving up our rewards and the value of everything we accumulated so far. We'd be giving up the value of our equipment for what? To theoretically steal some cryptocurrency and quickly sell it? And, if we couldn't sell it fast enough—even if we could avoid apprehension—we would have

FRMO Corp. Q2 2018 Conference Call
Tuesday, January 16, 2018

destroyed not just what we had accumulated, but also what we stole. That's a very powerful disincentive.

As I mentioned previously—and I just want to underscore this point—we're getting a very high return on capital. That's the incentive to operate the system. The bitcoin cryptocurrency was designed to reward the miners more or less with whatever inflation exists in the system. You might say, other than the genesis block and the initial accumulation, it was almost an act of love, because no one knew if the cryptocurrency was going to be worth anything.

For the most part, the new genres of cryptocurrencies don't work that way. They work much, much more like an initial public offering. A person or group designs a currency, which might actually be solving a need, but which also has what you call "proprietary technology." Therefore, a great number of coins are held back for the creators of the system. If the currency is to have a sensible monetary policy, there can be very little new coin issuance, if any. Since the sum of the parts must equal the whole, the creators will hold back a substantial amount of cryptocurrency, which means there won't be much left for anyone to mine or receive as a reward for operating the system.

There are many different ways to compensate those who operate cryptocurrency systems. One way that I personally am not a great believer in, but a lot of people seem to believe in, is something called proof of stake. As I said earlier, bitcoin is proof of work, meaning the operators, or the miners, actually solve very complicated algorithms. It was designed that way so that the operators have a lot of skin in the game. It was designed as a deterrent to those who might want to engage in a denial of service attack, or to hack the system, since an enormous investment in equipment and power—not just a small investment in one personal computer—would be required to make such an attempt. That's why it was done, to basically create a barrier to anyone trying to damage the system.

In a proof of stake system, however, operators must buy a certain amount of cryptocurrency that they then put up as collateral. Believers in that system say that it's a much more sensible approach, but I don't agree. They think it's a more sensible system, because it doesn't require a lot of electric power and investment in computer equipment. They think proof of work is very wasteful, and instead advocate using the cryptocurrency itself as collateral.

But what return can you expect on your proof of stake venture? There are circumstances in which you could lose that proof of stake, or it could be hacked. I'll use one cryptocurrency as an example: it's called Qtum, which is basically a proof of stake system that in a bizarre way is derived from bitcoin. Participants in the Qtum system must put up this currency as their collateral. The system is operated entirely by personal computers, so you hook up your personal computers to a vast network, and that's the operating system. Sounds great, except that as the proof of stake operator, you are obliged to have your personal computer on 24 hours a day, seven days a week.

FRMO Corp. Q2 2018 Conference Call
Tuesday, January 16, 2018

I'll give you a pedestrian example to illustrate the challenges in the Qtum proof of stake system. You have to be in the operating system for a while and stake your money before you're even eligible for a reward. If you get a reward, unlike bitcoin, it's not paid out to you immediately; instead, it's paid out over a certain period of time. If, at any point in that time, even for one minute, your personal computer goes down, you won't get the reward.

Let's say it's an iMac, and Apple is performing some type of system update or upgrade, like they do all the time. To fully install it, you have to turn your computer off, perhaps only for a few minutes. As far as the Qtum system goes, you're out of luck: no reward. Or let's say the power goes off for a minute, or somebody walks by your PC and hits the plug, which falls out of the outlet, or a vibration causes the plug to disengage enough to cut the power to the computer, or any one of a number of causes. If the computer goes off, no reward.

That's just one circumstance. Another, which is no less common, is that the payment is not very high. In other words, the return on your cryptocurrency stake, as measured in that cryptocurrency, is not very high. If you buy a certain amount of a proof of stake cryptocurrency, you might get a return of 1%, 2%, or 3%. Why should I stake money to possibly get such a small rate of return, and that's only if everything works right? I am taking risks: my computer could be hacked, my wallet could be hacked and my cryptocurrency could be stolen. Any number of disasters could befall me if I haven't taken the proper precautions, which I wouldn't be able to take, because I would have to leave my computer on constantly. Other people could get to know what's going on in my personal computer, and I don't feel all that secure about that. You see what the problem is.

The reason these cryptocurrencies don't offer a higher return on equity is because every unit of currency the creators give to the operator is one unit fewer for the creator to keep, because the sum of the parts has to equal the whole. I find the returns for operating the system on most of the cryptocurrencies are very small. They're certainly not intriguing enough to attract me.

In bitcoin mining, the expenses are denominated in fiat currency. You have to buy a machine, pay for electric power, and pay for a place to host it. All those expenses are paid in fiat. You receive payment in crypto. It's not guaranteed, but it's possible that the costs could be low relative to the value of the crypto, resulting in a very high rate of return on equity, which we have actually earned on our mining equipment. When we discuss the dividend, you'll see that we've had an amazingly robust rate of return relative to how much we invested. That doesn't mean it's going to last forever but, at the moment, it's there.

In crypto proof of stake systems, you get a certain amount of payment in crypto in relation to a crypto stake. You can make it a robust rate of return if a very small number of people are willing to do proof of stake. Whatever the payment is, it will be divided among very few people. The trouble with that is, if very few people are willing to do proof of stake, the

FRMO Corp. Q2 2018 Conference Call
Tuesday, January 16, 2018

system will not be robust. A higher return on equity in a currency without a robust system makes it much less secure than a system with more operators or nodes.

Another point to remember about these new currencies being issued is that they're just beginning the issuance process. The creators of the cryptocurrencies are similar to owners of companies that bring an IPO to market; sooner or later they get around to selling their stock. In the case of cryptocurrencies, there will be a tremendous supply of those cryptocurrencies on the market when all of these creators seek to cash in. That's in contrast to bitcoin, which has already issued over 80% of all the bitcoin that will ever exist. The remaining less than 20% will be issued between now and the year 2140. So, each individual cryptocurrency has to be evaluated in terms of its supply/demand characteristics.

I'm sorry for the elongated response, but I feel it's important because people are paying attention to FRMO as if it were a cryptocurrency LLC. For those who are looking at it that way, I think you have a right to certain information.

As to the part of the question asking what would cause us to change from a buyer to seller of crypto-related assets, first let me make a minor point. As I stated before, cryptocurrency assets are not homogeneous. There are major differences among the currencies with respect to the coin issuance policy, in the robustness of the network, in the incentive for operators to behave themselves, in the incentive to operate the system. So, it's hard to generalize.

However, if the people who operate or who control every cryptocurrency were to get together and turn it into an issuance machine, then it would be no different from fiat currency. If that were the case, I'd sell in a heartbeat. Of the 1,400-plus cryptocurrencies, you'll find that we own only a handful. They are the cryptocurrencies that are not controlled by a group of creators and are not involved in heavy issuance, which is to say that they have a sound monetary policy.

Cryptocurrencies only make sense if they are an alternative to fiat in terms of issuance. If it's like fiat or worse in terms of issuance, I would say, just like Warren Buffett and Charlie Munger do, "Stay as far away as you possibly can." For the balance of these currencies, we have done that, and we will continue to do so.

Question 6

How confident are you that the value of cryptocurrencies will eventually become equal to the value of all fiat currencies?

Murray Stahl – Chairman & Chief Executive Officer

I'm actually fairly confident that will happen, with the caveat that it will be limited to those cryptocurrencies—however few they are—that have a sensible monetary policy. With a

FRMO Corp. Q2 2018 Conference Call
Tuesday, January 16, 2018

sensible monetary policy, which means they don't issue a lot, or they issue virtually nothing, then the creators aren't going to get paid, because there's the economic principle called Gresham's Law that basically states that bad money drives out good. All that means is that people figure it out, and withdraw the more scarce or good currency from circulation and hang on to it; there comes to be less and less of that in circulation, and more of the bad currency. Cryptocurrency will equal the value of fiat currency only for those cryptocurrencies whose issuance policy is superior to that of fiat. Fiat currencies are very aggressive in terms of issuance, and very aggressive in terms of the policy actions they're interested in taking. There is paper being created all the time in the world of fiat.

I think that if the crypto originators could contain themselves, the future of crypto would be very bright. But, as I said in the previous question, unfortunately, the bulk of them cannot contain themselves, because it's nothing other than a Get Rich Quick scheme to them. The only difference between them and the government is, in the government's case, the money goes to the government and it debases people's purchasing power. In the case of the cryptocurrencies, the money goes to the creators, so I guess it debases people to the extent that they own that cryptocurrency. But the whole idea of cryptocurrency is a controlled supply, and hopefully, eventually, a safe, fixed or nearly fixed supply.

Question 7

How many funds does Horizon Kinetics now have focused on cryptocurrencies and related companies?

Murray Stahl – Chairman & Chief Executive Officer

The mutual funds have cryptocurrency exposure, but really only to bitcoin, because that's all we can do in the mutual funds. The hedge funds have a little bit wider exposure, but they're not cryptocurrency funds; they're focused on other investments. They just happen to have successful cryptocurrency investments in them.

We really only have one cryptocurrency fund, and that has various classes. One class might be bitcoin, another Bitcoin Cash. We might have a class with a variety of cryptos in it, and so on. They're all contained within the same fund, but in different classes of that fund. But I wouldn't really consider it a cryptocurrency fund, because there is a small-cap element to it that has very little to do with cryptocurrency.

Question 8

What can you tell us about the new investment partnerships?

FRMO Corp. Q2 2018 Conference Call
Tuesday, January 16, 2018

Murray Stahl – Chairman & Chief Executive Officer

I just told you something about new investment partnerships, so I'll talk about the cryptocurrency mining LLCs. They're not really funds, and not really partnerships; they're LLCs. The intent is for them to become standalone companies one day.

The idea is for them to operate in a network within the context of several cryptocurrencies. In the cryptocurrency LLC we have right now, we're mining a variety of cryptocurrencies, including bitcoin, Bitcoin Cash, Bitcoin Gold, Zcash, Ethereum, Ethereum Classic, and Litecoin. I think we just started mining Litecoin a day or two ago. If I'm wrong, it's by a couple of days. But the equipment, I believe, was delivered and installed.

Anyway, the idea is that we get a certain return for the work we do. In one flavor, the crypto will be sold for fiat, and that fiat, which is all the profits of the company, will be distributed to all the shareholders. In the other flavor, we'll hold onto the crypto. People can choose which flavor they want. The idea is to create a liquidity event for the limited partners, meaning that the funds will no longer be private partnerships. The liquidity event is desirable, because the funds are not going to hold tradeable securities. Yes, there will be the fund that holds coins, and that's an asset that could be sold, but there is mining equipment as well, and that's not so readily disposed of.

Ultimately, when the funds have enough money, they'll become publicly traded companies. We will manage them, but they'll be publicly traded. Then whoever owns them will have a liquidity event: they can sell the shares or hold them. There will be a one-time fee for us, if we can successfully bring it public. But the important thing to understand is that, if they really produce very robust returns on capital—and I'll explain why I believe they can in a minute—then we're paying out the robust return on capital to the shareholders, so the public entity should trade at a very big premium to book value.

Until we bring it public, it will be valued at net asset value, which is basically book value. We'll depreciate the assets (the equipment), but hold back enough cash to buy equivalent assets. Basically, that's what's going to happen; nothing other than that. If it has the robust return that we expect, it should trade at a big premium to book. If investors like that, they can keep it; if they don't like it and they want to cash in on the premium, they can sell it.

I'll add a word or two about these mining networks, and why the returns are robust. Understand that cryptocurrency operations work entirely differently than normal business operations. I'll use Google as an example, but it's true of any business. A company in any normal business will be the most profitable if it is the most efficient. In the world of search engines, with due respect to the others, Google is the most efficient. Not only does it have a high return on equity, but it reduces its prices to a level at which other companies find it very difficult to compete, so Google gets a very high market share. That means the market leader in most business circumstances is setting a ceiling on the return on equity that

FRMO Corp. Q2 2018 Conference Call
Tuesday, January 16, 2018

everybody else can earn. Those that can compete will earn a lower return on equity, for the simple reason that they're less efficient.

In crypto, it's important to understand that the ledger is distributed. If one company—meaning a miner or mining entity—were to become more efficient than all the others, there wouldn't be a distributed ledger. If one company, or one group of people, controls the ledger, then it's no longer distributed. It's not a blockchain; it's just a single-point-of-failure software program that ultimately anybody could hack if they had the willingness and determination to do so.

A distributed ledger needs a multiplicity of nodes, tens of thousands of them. A node should be synonymous with an operating system. The system has to provide a sufficient return on equity to allow the least efficient node to make a sufficiently robust return on equity to keep that node in the game.

Therefore, in the cryptocurrency distributed ledger system, the least efficient node sets the floor of return on equity. This least efficient enterprise or group of people, or maybe even an individual person, will have a return on equity adequate to keep them in the system even though all the other participants in the system are more efficient and will have higher returns on equity. It's just that the lowest return on equity is sufficiently robust to keep that least efficient node in the system.

This way of thinking is completely different. The idea is not to drive everybody out of the business because, if you did, it ceases to be a distributed ledger. Then it wouldn't really be a cryptocurrency; it would be just a single point of failure currency that happens to be electronic, which we already have right now with Visa and MasterCard.

That's a really important concept to understand, and it usually takes a long time before people fully understand it. As you're grappling with that idea, let me lay on another difficult to understand concept for your edification. When one hears these discussions about cryptocurrencies, they frequently say something like, "Which technology will win?" There are more than 1,400 cryptocurrencies, so that would be a very hard problem to solve. I certainly would not be able to solve it.

But the question itself is preposterous. Why? Because cryptocurrency software itself, the code, is open source code. It's available to anybody. If a certain cryptocurrency has some unique features that I would like to include in my cryptocurrency code, whatever that happens to be, I could just use it because it's open source software. By the way, even if you don't know a lot about coding, they've now created utilities that make it possible for people to create a currency, even if they're not crackerjack computer programmers. It enables them to integrate elements of other people's open source code into their cryptocurrency. That's why these currencies proliferate so rapidly.

FRMO Corp. Q2 2018 Conference Call
Tuesday, January 16, 2018

In the world of bitcoin, there is a tool called ForkGen, which is short for Fork Generator. If desired, you, too, could create a bitcoin fork, which is a different version of the bitcoin blockchain that runs on a different protocol immediately following the fork.² Using ForkGen, you could do it yourself.

Asking the question, “Which one will win?” would be totally appropriate if the competing currencies used proprietary technology that can’t be copied, but none of it is proprietary. To show you how nonproprietary it is, I encourage you to visit a website called GitHub. There are many websites like this one, but I’ll use GitHub as an example.

You might say that GitHub is like Facebook for computer experts, except you don’t have to be a computer expert to participate. You might be someone who is very knowledgeable about computers and is trying to bring a certain project to fruition, but you lack a certain necessary skill set. On GitHub you can communicate with endless numbers of likeminded people. You might meet people who have the skill set you seek, and you could collaborate with them on finishing the software you’re working on.

Or, you could be someone who has basically no knowledge of coding whatsoever, but you have a really interesting idea for an application. Wouldn’t it be nice if the computer could do A, B, or C? You could go on GitHub to find likeminded people, some of whom are highly technically proficient, and you could organize yourselves any way you care to. You might very well develop an app and sell it on the GitHub. Why would you sell it on the GitHub? Because GitHub provides, for free, all sorts of programming tools to make your life easier. It’s very similar to how the internet became the internet when JavaScript became available to everybody. It’s hard to imagine, but there could never have been a Facebook without JavaScript. There’s nothing proprietary about these tools.

If you will permit me to take that analogy one step forward, there’s now a second way of organizing people for a business objective. The corporation, which was invented in the 19th century, is one way of organizing people and putting capital to work. Unfortunately, or fortunately, depending on how you look at life, it’s not the only way anymore. People can be on GitHub and organize themselves any way they want. The structure doesn’t have to be a corporation, but even if it were a corporation, it wouldn’t have to be a listed corporation; it wouldn’t have to be available to the public.

Anybody can do it. There’s no barrier to entry anymore; anybody can compete with the technology giants, or any kind of giants. We might admire Amazon for the way it has been able to provide a pathway to getting cheap products sourced from all around the world, but there’s nothing to stop anybody from creating a system that shops for products directly

² A bitcoin fork is more akin to a “save as” instruction on a personal computer, because holders of bitcoin before and up to the fork receive the new currency in amounts equal to their bitcoin holdings at the time of the fork. In other words, both currencies have identical blockchains up to the fork, then the new currency’s protocol takes effect and the blockchains diverge.

FRMO Corp. Q2 2018 Conference Call
Tuesday, January 16, 2018

with the manufacturers. The manufacturers could ship directly to customers and bypass Amazon. That might actually happen. Anyway, GitHub is just one of these types of sites. You can see exactly what I mean if you take a look at these websites. They are a veritable lodestone of activity.

The corporate hierarchy will not cease to exist, but now there are many different ways for human beings to organize themselves. This activity is no longer dependent upon a hierarchy, because the knowledge resides everywhere. Since the knowledge isn't proprietary anymore, everybody has to change their focus. There aren't winners and losers in the conventionally understood sense of the word anymore. There are only practitioners. It's very hard to keep things secret.

Even among the tech giants, they don't seem to be producing the breakthroughs that we used to see. You might disagree with me on that, but I think if you go on GitHub, you'll see very clearly what I'm talking about.

Question 9

The recent tax law changes have provisions that target offshore reinsurance. Recognizing that it is early days, what impacts could these changes have on insurance-linked securities and the Bermuda Stock Exchange?

Murray Stahl – Chairman & Chief Executive Officer

It's way too early to tell. Insurance-linked securities are in a niche market right now. For them to be more successful they will have to expand into a much greater multiplicity of risks. That's the challenge for expanding that market. Therefore, if the insurance-linked securities market evolves the way I think it will, it will be a worldwide market, like Lloyd's of London. Buying different insurance-linked securities is really the equivalent of participating in pools, such as the Lloyd's of London market.

That could happen one day and, when it does, it will be a different asset class. There are many technical and legal questions to be answered, because some of the risks are highly complex. How you combine that risk into a security is not an easy problem to solve, but there are people working on it. So, that could be interesting.

Question 10

Can you give us an update on crypto activities and suggest what impact the recent regulatory decisions might have?

FRMO Corp. Q2 2018 Conference Call
Tuesday, January 16, 2018

Murray Stahl – Chairman & Chief Executive Officer

I'll use this question to expand on my previous comments on cryptocurrencies. Since the last conference call, futures are now available on bitcoin, and I believe we'll have futures on other cryptocurrencies as well. I also believe cryptocurrencies will become a legitimate asset class.

The fact that there are futures means that, on a first-order level, regulations are being imposed that are similar to those on stocks, because the exchanges trading the futures—currently the CME and the CBOE—are self-regulatory organizations. The SEC doesn't regulate futures but, remember, there were exchanges for 140 years before the SEC was even invented. If stocks and bonds could trade for 140 years and be very successful as asset classes without the direct intervention of a regulator that didn't even exist yet, I don't see any reason why cryptocurrency couldn't exist in the absence of regulators.

In Japan, for instance, cryptocurrencies are receiving fairly intense regulatory scrutiny. The same goes for Switzerland. I believe those two countries will set the model. Before very long, we'll have a working set of regulations for cryptocurrency. When it happens, it will have a positive impact.

Though not necessarily germane to this question, it's very important to note that the big challenge for crypto is the speed at which transactions are processed. This issue is particularly true of bitcoin, but it's true of others as well. Bitcoin has a 1-megabyte limit on how many transactions can be included in a block, and a block cycles every 10 minutes.

To clarify, consider that 1-megabyte block as the width of a road that is not wide. Many think the solution would be to make the road wider, and that's one solution. But there are a multiplicity of other solutions in development. Within a month or so, I believe four of them will be available. They all come under the heading of Bitcoin Lightning. The objective is to make bitcoin processing as fast as that of Visa. I've seen two of them demonstrated. I can't tell you that it will work, but it looks to me like it will work, though I don't know that for a fact. If it does work, it will cause a revolution in cryptocurrency.

At the end of the day, even though these problems might not be solved in the next month or so—although they might be—they are solvable. Don't forget that in 1958, Visa, which was the BankAmericard when it started, had plenty of problems. It certainly wasn't as fast as it is now. We didn't have the computer systems we have today, and it took decades for that to evolve. One should never think that cryptocurrency is standing still. If you visit the GitHub website, you will see it's certainly not standing still. And neither is the larger world of software.

If you own a lot of tech companies, and you see the proliferation of activity and the fecundity of it, I think it could make you very uneasy to see the competitive forces that, sooner or later (and I think sooner) will be brought to bear that could basically make

FRMO Corp. Q2 2018 Conference Call
Tuesday, January 16, 2018

technology nonproprietary. That's what it's all about: nonproprietary technology competing with technologies that purport to be proprietary. The proprietary company might have 1,000 or even 3,000 employees in its research and development department, which is a very impressive number. But the worldwide community has literally tens of millions of people working on the same problem. There's just no contest.

I'll leave you with that thought. Thank you for these questions that I think are excellent. I hope I've answered them, and please keep them coming. We look forward to reprising this again in three months. Good afternoon to everybody, and let's keep up the dialogue. Thanks so much.

OPERATOR: Ladies and gentlemen, this concludes today's conference. Thank you for your participation. You may now disconnect.

FRMO Corp. Q2 2018 Conference Call
Tuesday, January 16, 2018

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