Operator

Ladies and gentlemen, welcome to the FRMO Third Quarter 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, Aaron. 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 2016 third 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. Rather than launch directly into a review of some of the line-by-line items on the balance sheet, as we seem to have been in the habit of doing, I thought I would start with some of the questions that were presented to us before the call. In answering them, I think we might address some of the salient aspects of the balance sheet that probably catch observers' attention, and which relate very much to the observation that the shareholders' equity is lower.

Question 1

Can you help us to better understand the significant changes in the cost basis and unrealized gains in the investments? In particular, there was a big decline in the Horizon Kinetics Multi-Strategy Fund. Is this due to a distribution or a sale of our ownership stake? Likewise, the cost and gain profile in your equity and debt securities has changed dramatically; you have made many new investments, and sold a few, but it appears the portfolio was hit pretty hard in the first two months of 2016. Is this why deferred taxes declined? Some taxes were obviously paid on the recognized gains.

Finally, on performance, the first nine months of the year have seen a pretty dramatic (and unusual) reduction in the book value of FRMO. To what extent do you see these losses as permanent, and to what extent are they simply market error?

Steven Bregman – President & Chief Financial Officer

If you look at the balance sheet for February, you'll see that a meaningful part of the reduction in book value was that Current Assets, Other Investments Available for Sale was $11 million lower than the May 2015 number. It was $29 million and change versus $40 million and change. And the paired deferred tax liability you'll see was lower by about $4.5 million. If you net those two, that's about a $6.5 million difference out of the $9 million reduction in shareholders' equity.

There's another item, a liability, that was about $5.5 million higher, and that's Securities Sold, not yet Purchased. Those are short sale positions from which we believe we will have a high rate of return. I daresay Murray might speak a little more to this, since he was in charge of those transactions. This is a class of transactions from which we've earned quite substantial returns over time, but they start off at market value when we sell them short. Eventually, those decline, if things turn out the way we expect.

I would suggest, though I can't say, that substantially all of the decline in shareholders' equity can be attributed to temporary market movements in valuation and also perhaps the initiation of a short sale program for certain assets. Murray, would you like to talk for a moment about the short sale positions?

Murray Stahl – Chairman & Chief Executive Officer

First I'll talk about the Investments Available for Sale and then the short sale positions. I don't want to give you an impression that we've added very much there. In Investments Available for Sale, there's not a lot of new activity. We've realized gains, some of which were in the various funds, resulting in a new cost basis. I wouldn't want to give you the impression that we're doing a lot of trading there. There are some small items, but nothing that I would say is salient.

Regarding the short sale positions, I used to like to say, "Look how wonderful it is; here's the cost basis of what we sold short, here's the market value, and here's all this money we made." In January, we ended up realizing some of the gains from the short positions. We established new shorts, which I'll talk a little about, but we realized some gains, and we had to pay taxes on them. Now we have a new cost basis with the new shorts.

Bear in mind that we closed some short positions and, unfortunately, it cost us a lot of money in taxes, because we closed them at zero value. And I don't mean "essentially at zero value," I mean actual zero value. Why did we close them at zero value? Because they were options and they expired worthless.

What I like to say about the shorts in general is that our approach relates to what we would call dysfunctional or path-dependent exchange-traded funds (ETFs). There's a good part to it and a bad part to it. Naturally, you would want to know the bad part first. The bad part is that there are so many choices of things to do (which is also the good part), that we use options and other instruments. We also are able to use hedges, which we were never able to do before. It's all to the good. The only bad aspect of it is that we can't hold them forever, at least some of them; therefore, we have to realize gains. When we realize gains, we have to pay taxes. We really don't want to pay the taxes but, unfortunately, it's unavoidable.

That's the bad news. The good news is that it's becoming much easier to execute this strategy. We have a panoply of choices available. As a consequence, you'll see more of this activity. Later on, I'll come back to this point, because there are other ways to look at this situation. But I don't want to detract from what Steve is going to say.

Steven Bregman – President & Chief Financial Officer

Looking at the balance sheet, you can't engage in an accounting analysis of market value versus cost basis, since it includes not only the value of securities directly owned by FRMO Corp., but also those within the various funds, which had some of the same investments. In January, we had certain option positions expiring at 100% profit. We also began to reduce the leverage in the Horizon Multi-Strategy Fund and also in individual accounts that are managed at Horizon Kinetics. We began increasing our liquidity in accounts and investment strategies, and reducing leverage, starting back in the middle of the year, bit by bit. In that process, some of the securities sold had significant gains. They were the path-dependent types of trades involving short-sales that produced a fair amount of profits. That just upended the cost-to-market-value relationship.

As far as the big decline in the Horizon Kinetics Multi-Strategy Fund, there were redemptions on a net basis but, as well, the bigger impact, off the top of my head, was from performance, so that partly the big difference you see has to do with the timeframe of May 31, 2015 to February 29, 2016. Although the Multi-Strategy Fund was down probably on the order of 12% on a calendar basis, if you take it from May of 2015 through the end of the calendar year, you leave out, unfortunately, a few positive trend months, and the first two months of this year were down about 6%. You actually have a fairly sharp negative performance for the period from the end of May 2015 through February 2016. It could be well north of 25%, although March was a pretty good month. But that was probably the primary impact upon the market value.

Question 2

Why is South LaSalle Partners deemed an available for sale investment? Is it because of a minority interest in South LaSalle (the General Partner could choose to sell or liquidate), limitations on ownership of exchange seats, or is it because you have less commitment to this investment than to other exchanges? Commentary on your previous call indicated a desire to collect more of these "croupier" investments. Moreover, much of the optionality embedded here seems to be long-term in nature, suggesting that the goal would be rather to retain this as a long-term investment.

Steven Bregman – President & Chief Financial Officer

The essential question asks why the investment in South LaSalle Partners is listed as a short-term investment when, qualitatively, we speak about it as a long-term investment. Murray, would you like to respond?

Murray Stahl – Chairman & Chief Executive Officer

Yes, I'll answer the question, but I'm going to hold it in abeyance for a couple of minutes because, first, I want to provide an overview of our thinking on several other subjects, and then I'll come back to this question.

It's no secret that over the years we've written about the money management industry, the world of options, and the world of indices. For the most part, although there's nothing wrong with holding an index over time—if you're a long-term investor, it's a perfectly reasonable strategy—in our opinion, it has led to certain distortions in the market. We've taken actions, both on the money management side of the business and on the FRMO side, to gradually move away from that arena. That's why you see all the liquidity on the balance sheet. Similarly, if you look at the various funds, you'll see a lot of liquidity there.

It's not merely the distortion from indexation, it's also the distortion that comes from the most accommodative monetary policies in history, not just in the United States, but around the world. You can't walk away from the fact that, if you're going to live in the world of close-to-zero interest rates or, in some cases, zero or negative interest rates, and have a 10-year Treasury yielding, let's say, 1.7%, then a perfectly garden-variety, pedestrian, blue-chip company that might not be growing very much—and I don't have to mention any names; you can guess what they are—and that might have been yielding 4%, now might yield 2.2%. If you think about it, 2.2% is a fairly substantial percentage increase from a 1.7% yield on a Treasury. Then, there's a tax advantage, because the dividend most likely will be qualified. The Treasury avoids state taxes, but gets hit with the full freight of federal taxes.

It's not that it's a distortion in the sense that XYZ Corporation is improperly valued if it yields 2%-plus and would be properly valued if it were to yield 4%. You could argue that a few basis points plus or minus is an appropriate valuation, given the company's characteristics. It's just that it can't stay that way. It can't. The only way it could stay that way would be if interest rates either go lower—which I guess is possible, but it's rather difficult to imagine—or, if interest rates stay as low as they are for a very prolonged period of time.

I have to tell you, the latter is somewhat easier to imagine but, if that were to happen, there could be all sorts of frightening consequences. It's not merely the distortion of asset prices or that people might be engaged in dysfunctional activities. You might have seen, some weeks ago, a story about the City of Chicago being downgraded by Fitch to one notch above junk. That's because the City wanted to unilaterally revise its pension fund payments to beneficiaries, but the courts ruled against it.

Don't forget, the bond market is five times the size of the stock market worldwide. Low interest rates play a very important role in preventing pension funds from earning the rate of return they require. It inhibits the returns of foundations, endowments, and even cemetery trusts. It's a very, very serious problem that is not going away; it's getting worse.

In an investment sense for FRMO, or in a money management sense for Horizon Kinetics, you could run towards that, and do the best job you can, and buy securities like the blue chip companies I just described—you could debate which securities you want to buy—but, at the end of the day, your ice cube is going to melt. Even if your ice cube melts less than some other ice cube, it's going to be a serious process. When does that turn around? I'll answer that question later on.

Getting back to the short sale position, you'll observe that, basically, we have two significant sources of revenue. One is the revenue we get from the money management business and, ironically, when the money management business is, you might say, influenced in a negative way by indexation, on the positive side, it makes these kinds of short sales possible that in another environment might not be desirable to engage in. In this environment, however, it's actually a pretty good approach to use.

All these various investments that we've made over the years—OneChicago, HK Hard Assets, Digital Currency Group—I'm going to talk more about some of those in a minute. It's not exact but, in round terms, over the years, we've basically taken our income, after taxes, and funded purchases like these. We still have our cash, as you can clearly see on the balance sheet, and that cash is really great collateral. It's the best collateral you can have for pursuing more of the same investments.

There are many interesting opportunities. The idea is to take the FRMO cash flow, such as it is, and to invest in what might be called different kinds of exposures. I would say different kinds of asset classes, but maybe that's too extreme. I'll just touch on a few, because some I always touch on. We had a question on Digital Currency Group, so I'll answer it as part of this discussion.

Question 3

Would you go over the rationale behind the sizing of the new investment in Digital Currency Group and what sort of allocation we can expect going forward? On the previous call, it was discussed that due to the volatility of commodity/energy investments, FRMO's stake in HK Hard Assets LLC will be limited in size to reduce downside risk. However, at these sizes relative to equity, the investments will have to pay off many folds in order to move the needle. Kindly share your thoughts on this matter please. Moreover, as was the case for HK Hard Assets LLC, would you be able to comment on whether FRMO principals are invested in Digital Currency Group as well, and if so, what is the size of their investment relative to FRMO's stake?

Murray Stahl – Chairman & Chief Executive Officer

In the case of HK Hard Assets, we've been increasing our stake, and you should see more of that in the next quarter. You should see a gradual rise in these positions. When you're buying certain publicly traded securities, I'll just say this: it's not easy to buy an enormous quantity of it and not move the stock. You have to move gradually. Bear in mind that we're funding our investments through our cash flow, both our shorts and longs, and the money comes from Horizon Kinetics. On the short side at least, you can't control in what quarter you're able to realize the investment. It starts off small. Our plan is—and it might change—but our plan is to increase the size of that investment.

As to Digital Currency Group, it is a corporation that is devoted to crypto-currencies which, I believe, will be a legitimate asset class in short order. What is a crypto-currency? A crypto-currency is an electronic currency of which Bitcoin is an example. It may not be the crypto-currency that ultimately gains prominence, but that's not the thrust of this company.

We would have bought more Digital Currency Group, but that was all that was available. We also bought a modest amount for ourselves. We would have made a bigger investment for FRMO, but we chose not to because it's a brand new asset class. Before we make it a bigger stake, we want to learn more about it and get more comfortable.

Basically, Digital Currency Group has various venture investments in the field of digital currency generally. These are primarily the technologies involved in digital currencies. Digital Currency Group also has some operating businesses. For example, it owns something called Coinbase, which is an exchange that actually trades digital currencies. It also provides news and information on crypto-currencies. It has a company called Grayscale, which is entirely owned by Digital Currency Group. Grayscale is a money manager of crypto-currencies.

Why does the world need a crypto-currency? What might be the upside and optionality? Historically, as you know, governments around the world have had a tendency to either inflate assets, which is what they're doing right now, or inflate the currency, but we haven't seen a lot of currency inflation yet. In one sense, you might say the central banks of the world have had a little luck on their side because, in the last year and a half, most commodity prices have more or less collapsed. So, we didn't get the inflation normally associated with aggressive monetary easing, but we did get the asset inflation.

At the end of the day, if you're holding government securities or fixed income securities, and there is some inflation—it might not be much, but if there is some—and you know what the yields are, and you pay taxes on those yields, de minimis though they may be, little by little, you are being inflated away. You are losing purchasing power. That's been a constant throughout history. You can go back centuries and that's what governments have done.

Sometimes, there have been efforts to put nations on the gold standard, or to use commodities such as gold as a way of fixing the value of the currency. While that approach works to a degree, it leads to certain rigidities in the financial system, which is why a lot of people don't like it. It means that you can't expand the money supply when you want to in the middle of a crisis. Consequently, the crises are deeper and more serious when they occur.

However, it might be astonishing for you to learn that there are times in history when the mere fact of being on a metallic standard created inflation. For example, in the 16th century, when the Spanish empire colonized South America, they found a lot of silver and gold, which made its way to Spain and, eventually, to Western Europe. Because silver and gold were used for currency, a great deal of money was issued, and this caused an enormous level of inflation. There are some historical economists who argue that Spain never recovered from that to this very day.

Similarly, if you look at the California Gold Rush, or the Klondike Strike in the late 1890s, or the discovery of gold in South Africa in the late 19th century, it is clear that these large discoveries can be disruptive events. The idea became so common in the 20th century that it was deemed undesirable for the economy or the money supply to be managed by happenstance, but rather, it should be managed professionally and the money supply should be controlled. That's basically what central banks do in the world. And they issue currency when they want to.

In the 19th century, banks could issue their own notes, and these passed for currency. The problem was that you couldn't control the banks, and there were people producing counterfeit bank notes. Eventually, it was decided that the best system was to give the government a monopoly on currency. But governments abuse that monopoly, and everyone knows they abuse it. If you have a money market account or some T-bills or short-term bonds, you're perfectly aware that they abuse that monopoly, and there was nothing to do about it until a digital currency emerged.

Bitcoin, as I said before, might not be the currency that becomes dominant, but let's assume, for the purpose of this discussion, that it happens to be the one. There will only be 21 million Bitcoins issued, ever, and the last Bitcoins will be issued in 2140.

There's a technology called blockchain, which isn't a sophisticated technology; it's just a public ledger that tracks every transaction ever made for each Bitcoin, or it can track other items. It's similar to looking at a ledger of the Treasury Department and seeing the serial number of every dollar, and knowing where every dollar is and where it has been. If you could know where every dollar bill with every serial number is and know where it has been, there could be no counterfeiting. If you could do that, you wouldn't need a government to ensure that you weren't holding counterfeit currency. It would, basically, eliminate counterfeiting. Everyone would be able to validate every transaction, because you could trace every single bill. That's basically what blockchain technology does for Bitcoin.

If there is a fixed standard of value, to the degree that people want to use currency to engage in more transactions, the currency will rise in value. Some people say—I don't say this, but there are some who do—"What if Bitcoin becomes the new gold?" Let's say that were to happen. Again, some people say it; I do not. But, if that were to happen, there's about $7 trillion of gold, and there's about $6.6 billion worth of Bitcoin in the world. Let's round it up to $7 billion. If Bitcoin were worth the value of all the gold—I don't even include silver, jewelry, art, or other hard assets, which would make a much greater market—in theory, Bitcoin would appreciate a thousand-fold.

If you want to let your imagination run much further, what if it actually became a currency for the world? I believe, if I'm not mistaken, there's $120 trillion in currencies, including dollars, yen, Canadian dollars, and Swiss francs, to name but a few. If Bitcoin were worth that, basically, you'd make 20,000x your money. Imagine if you made a $25,000 investment. Multiply that by 20,000, and you can see what could happen. Now, of course, you might lose it all, or you might lose a big part of it. In that case, you'd basically get a tax write-off; you wouldn't even lose $25,000.

Believe it or not, Bitcoin is making progress. There are family offices, quite a few of them actually, that are buying Bitcoin. The issues about safe custody and storage are technological problems that are being worked out.

Global multinational corporations have to pay bills in as many as 100 different currencies. In a working capital sense, it's very expensive to have small bank accounts for all these different currencies, especially when many of them are constantly depreciating in value. You can see the possibilities of having a crypto-currency that is instantaneously convertible into any currency in the world. It wouldn't cost a dealer spread because it's people matching to people, or what is called naked access, which is another issue that's interesting in exchanges, but I won't go into it now, because it'll take too much time. But it wouldn't take a lot to change Bitcoin's valuation tremendously.

Just as the investment in Digital Currency Group is important strategically, the Canadian Securities Exchange (which I discussed during the last conference call) is an important strategic investment because it ties in with hard assets. The price of commodities collapsed. While I don't say they're going to return to anything like their previous heights, let's examine the consequences if they were to rise in value a little bit, and let's use oil as an example.

If oil appreciates a little more from its current price—let's just say, for the sake of argument, that it goes to $45 in due course, maybe by the end of this year. Although it wouldn't be a very great recovery, I'm sure it would be very welcome for the oil producers. It might be enough to raise gasoline and other prices, such as those of plastics. Next thing you know, instead of a 1.7% CPI, it's at 2.3%. It might not be a big deal but, if it were at 2.3%, the Federal Reserve's hands would be tied. If that were the case, they'd have to raise rates. If they were to raise rates, then we would be back to what I was talking about originally: the market. There'd be problems with conventional equities.

If you want to be in the money management business and want to invest your capital while in an environment of what I believe are the lowest interest rates we have ever had—including the Great Depression—and since many financial assets are valued in relation to interest rates, and I think properly so, you will see what's going to happen. You should expect to see, if we can do it, more types of diversification to give us expertise in more types of asset classes, because the money management business is going to have to change. It can't just be—and I'm using a pejorative term, and I really shouldn't do it, but—it just can't be buying a group of securities that happens to have gone up for 35 years, because interest rates have been coming down for 35 years.

Then, from a selfish FRMO standpoint—and I've made this point before—we can't be two guys picking stocks and expect to have a successful corporation in that environment. We have to diversify into other businesses. You can see that we're diversifying while still maintaining an anchor in financial services. Some of the new assets are related to that concept. Even HK Hard Assets, in its own way, in theory, could be a fund that raises outside capital. At the moment, we don't have any desire to raise outside capital but, if we ever do, it's possible.

Strategically, that's what's going on in FRMO. Practically speaking, you can see the liquidity at a high level. You can't see all the liquidity in the funds, but there's a lot of liquidity there, and there's a lot of buying power in addition to the liquidity that's observable, because we haven't used it. We could use margin, and we could borrow money if we wanted to. We don't really have any desire to do that, but we could. Therefore, there's a great deal of pent-up power here.

Importantly, there's a lot of optionality here. I'll just mention it in passing. This time, I'll use the Canadian Securities Exchange as an example. Last time, I used the Bermuda Stock Exchange as an example. The Canadian small-cap market is not only negatively impacted tremendously by, I believe, the worst commodities recession in history, but also by small-capitalization stocks themselves being out of favor. This asset class required its own separate exchange just to serve its needs. One day, maybe in the not too distant future, who can tell, those companies will need to raise capital, and the exchange might be a very robust mechanism. It's important to bear that in mind.

Our small investment of only about $213,000 is 1.41% of the Canadian Securities Exchange. You can take $213,000 and divide it by 0.0141 to find the theoretical market capitalization and see where the exchange is valued. I leave it to you to calculate what would happen if there were to be a more robust environment for that genre of security, how much business they could do, and what such an exchange might be worth.

That gives you an overview, and I'll talk about some of the other items in the context of the questions. First, I'll repeat the one that I previously stopped Steve from letting me answer.

Question 2 (repeated from page 4)

Why is South LaSalle Partners deemed an available for sale investment? Is it because of a minority interest in South LaSalle (the General Partner could choose to sell or liquidate), limitations on ownership of exchange seats, or is it because you have less commitment to this investment than to other exchanges? Commentary on your previous call indicated a desire to collect more of these "croupier" investments. Moreover, much of the optionality embedded here seems to be long-term in nature, suggesting that the goal would be rather to retain this as a long-term investment.

Murray Stahl – Chairman & Chief Executive Officer

By the way, I might add that the questions, as a generalization, are quite stimulating and insightful, and this one is a prime example.

Generally, we can do two things with South LaSalle Partners, most of which is composed of the Minneapolis Grain Exchange. We could make it a long-term investment, or we could make it available for sale. If we were to make it a long-term investment, the accounting treatment would be to carry it at cost and the auditors would test to see if that was an appropriate valuation or not. Every now and then, if it were to go down in value, it might have to be written down. Then the question always would be: what's the market value of the investment? Everybody would be asking that. Accordingly, rather than carrying it at cost in a long-term category, why not make it available for sale?

There's a second reason that's more detailed. When you ask about the change in the shareholders' equity, you will observe that we didn't really do anything with South LaSalle in a material way. It declined, you might say, $1.5 million from May 2015, but it didn't really decline, because nothing changed. The auditors merely changed the way they valued the investment.

The auditors of the South LaSalle fund—who, appropriately, are different from the auditors of FRMO, the company—are always looking for the most conservative way to value the asset. If you follow the Minneapolis Grain Exchange, you might be aware that long time periods can elapse between transactions, and even when a seat does change hands, it might not necessarily be indicative of the value of the exchange.

Historically, since a long period of time could pass—sometimes many, many months—without a seat sale, we wouldn't have a benchmark. The process was to take the average of the bid and ask—which, by the way, is something like 33%, so it's big—and average it against the last sale. The fund auditors would say, "Well, that's not sufficiently conservative. It would be much more conservative if you simply took the bid." Now, we are not going to undertake to second-guess the administrators and auditors of the fund. If that's what they want to do, that's what will be done, because we prefer not to have any role in valuing a balance sheet asset like that. However, we can express an ad hoc opinion. I don't think there's any harm in that.

So, consider this, if you will, because occasionally we do buy seats. If we were buying a seat, then *we* would be the bid. Obviously, if you're going to use the bid to value the investment, and we have the opportunity to be the bid if we chose to, it seems sort of ridiculous to give us the opportunity to effectively value that holding in South LaSalle. We really don't wish to have that power but, unfortunately, it was granted to us. We don't abuse it; it's just a consequence of the situation. This is, probably, more information than you want, but you might as well have it.

You probably read about the possible deal between the London Stock Exchange and Deutsche Bourse. If that happens, that's going to be the last of the big exchange deals. Why has there been all this consolidation among big exchanges? First, because they want an economy of scale and to eliminate certain duplicative processes and expenses. Second, similar to any company or any group that forms an oligopoly, they want to raise prices on various services. But when they do that, they make the participants very angry. There's been a movement afoot to move businesses to other venues. However, not many places have the licenses. Today, you can move a business anywhere that has the appropriate licenses, because the trading is all electronic.

As a result, the optionality in small exchanges is huge, which is why we have them. There will not be many new licenses granted—maybe even none at all—and I'm sure the regulators want to have some competition. It doesn't take much in the way of moving business from Exchange A to Exchange B to really transform the character of the investment enormously, even without new products. Consequently, it's quite an interesting investment, and that's why we have it. And that's probably more than you wanted to know about South LaSalle.

Let me go on to some other questions on topics that we already touched on, but I'll go into a little more detail.

Question 4

Regarding performance, the first nine months of the year have seen a pretty dramatic (and unusual) reduction in the book value of FRMO. To what extent do you see these losses as permanent, and to what extent are they simply market error?

Murray Stahl – Chairman & Chief Executive Officer

Well, you can see $1.5 million of it in the case of South LaSalle, and I don't think that's permanent at all. For the rest of it, in March and to the extent we've had April, we're up a fairly decent amount. Give or take a few dollars here and there, I daresay we're at a comfortably higher shareholders' equity. When you see the financial statements for May 31, barring any dramatic changes, I think you'll see that confirmed.

Question 5

To what extent do you see the trend toward indexation as a form of herding/performance chasing, with big liquid stocks getting bigger and more liquid, and small illiquid stocks getting smaller and more illiquid?

Murray Stahl – Chairman & Chief Executive Officer

There is something to that; it is happening, but it won't go on forever. However, as I've said before, the more important variable is the valuation, and I touched on valuation, so I don't think I need to repeat myself. Even more important than the valuation is that if you were to study these big liquid companies in the aggregate, with some exceptions, they dominate their industries; therefore, people feel very comfortable with them. The trouble is that these companies are not growing their revenues, because they dominate their industries. They're not able to effect the mergers and consolidations as they once did when they were smaller. That's an issue. Then there's always competition, because the biggest companies are the ones that are always under assault. It's basically a very dangerous place to be.

My final point, which is perhaps the most important, is that if you look at some of the more focused indices, you'll see a trend of the big liquid stocks having a large weight. You can look at just about any index you want, and you'll see that trend. It's not so much that the small illiquid stocks are getting smaller and smaller; what's happening is that the big liquid stocks are getting bigger and bigger as a percent of the index.

You might say, "What's wrong with that?" Here's what's wrong with it. The whole idea of an index fund was to remove the individual, idiosyncratic security risk. That was the idea. If an index—and there are plenty of them—has one, two, or three companies comprising a large percentage of the holdings, how has that removed the idiosyncratic security risk? I saw a fund the other day for which the top 10 holdings were over 60% of the fund.

Steven Bregman – President & Chief Financial Officer

This is a blue-chip fund, with a very, very large amount of assets under management.

Murray Stahl – Chairman & Chief Executive Officer

Yes, a blue-chip fund with very large assets and its top 10 holdings have a 60% weight. As an example of this phenomenon, I'm going to use Exxon Mobil, because companies don't come much bigger than that.

Let's go back in time to April of 2013 and look at what the price of oil was. I think, if I'm not mistaken, oil was not far from $100 a barrel. If you look at most days in April 2013, Exxon was trading in the high $80s. Let's just say $88 a share. I'm doing this from memory, so I may be a bit off, but not by much. In that year, Exxon earned $7.40 a share. You can figure out the P/E. Today, the price of oil, is $41 a barrel, and the analysts who follow Exxon estimate that it will earn, I think, $2.30. I may be off by plus or minus $0.05, but some number like that. And Exxon trades at approximately $85 a share.

Its earnings are clearly correlated to the price of oil, but the stock price is not. You might be surprised at that, but do not be surprised. That's the way the world functions right now, because Exxon is not merely an energy stock, it's a dividend stock, and it's a value stock. If it buys back enough stock and its book value declines because it's buying back stock, it also becomes a growth stock. It's a Dow Jones Industrial stock, and so on and so forth.

That's a problem, because its valuation doesn't reflect the fundamentals of its business. You have two choices if you're in the money management business. You can enter the fray, try to develop products, and try to convince people to invest with you, because maybe you have a better view on Exxon or some other angle. The other choice, which is the one we're taking as you can see on our balance sheet, is not to enter the fray. We're going to have a lot of liquidity, and we're going to wait for something to happen, because we don't think this environment will continue forever.

Steven Bregman – President & Chief Financial Officer

Because something always happens. It never doesn't happen.

Murray Stahl – Chairman & Chief Executive Officer

It's true, what Steve just said, that the historical outcome for people who choose to buy at high valuations, generally speaking, is not good. Something usually happens, and there could be many different possibilities.

Question 6

Regarding benchmarks, if indexation is herding, then is not such performance chasing likely to continue for some time, particularly because the financial industry and academia are set up to recommend indexation as a strategy? Might we not see valuation extremes similar to those of 1999? If this is so, are not value investors, particularly small value, likely to underperform for years?

S&P 500 firms have earnings (unlike dot-coms) and a favorable strategy showing positive results. The amount of capital those funds can absorb is nearly unlimited, and the companies won't provide the clarifying event of bankruptcy to cause adherents to rethink the folly of paying 40x earnings. If that is so, comparing market results to market results is likely to be unsatisfying for most small value managers. Redemptions are likely, thus small value gets cheaper, but no managers can buy, because of benchmark risk.

Do we need a different benchmark? If so, what is it? Do we value investors have to focus more on P&L and less on the balance sheet (that is, carrying values)? If so, to what extent are you willing to help us by increasing disclosures on the operating performance of our investments?

Murray Stahl – Chairman & Chief Executive Officer

There are a lot of questions here. If you're talking about the various investments we've made in exchanges, because they're private companies, the information we can disclose is limited. The companies are private for a reason. In the future, however, to the extent that I can give you color on the direction of profits, I will certainly undertake to do that.

To the larger thrust of your question, I don't accept the premise that this environment will continue for some period of time, and the reason for that is multifold. I'm not sure I even agree with some of the premises in these questions. First, the big companies, by and large, have not grown their revenues and have not grown their earnings in the last four or five years.

If you were to take the top holdings in a typical dividend ETF, which I think represents a lot of what we're talking about here, and look at their earnings in 2011 and compare that to their earnings now, or revenues in 2011 to their revenues now, I think you'll see an ever-so-slight average deterioration. Even those such companies that have increased earnings haven't increased them by much.

The reason is that they're at record margins, and they're at record margins for several reasons. One is, to the extent that they use commodities as raw materials, which a lot of them do, it's been a bonanza, because the prices of meat, grain, oil, various metals, and others, have all declined tremendously. The companies haven't passed any of those savings on to the consumers. However, those commodities prices are not going to stay that low year in and year out; it just happened in the last 24 months. We have yet to see what will happen if commodity prices equilibrate even a little. I don't think the result will be very good.

Second, I don't see how interest rates can stay this low much longer. Even if there's no change in valuation, there will be increases in the cost of financing. There are lots of big companies that run negative working capital, which can be done if interest rates are zero. If interest rates are not zero, there's a real cost to doing that.

Steven Bregman – President & Chief Financial Officer

There's also the systematic issue upon which indexation, intrinsically, has been founded. It's a business that collects fees, and the fees have compressed towards zero in the commoditized ETFs.

Murray Stahl – Chairman & Chief Executive Officer

Yes, that's an important point. The big ETF companies raise billions upon billions of dollars a week, which sounds wonderful, except their fees are collapsing. To what end are they raising money?

There are other issues, and I'll just touch on them. One is that while you can buy a virtually unlimited supply of shares, only a limited number of companies issue such numerous shares. From the point of view of the ETF orchestrator, you can raise a great deal of assets, but you can't make a lot of money. From the point of view of the investor, yes, with a virtually unlimited number of shares, investors can invest trillions of dollars if they like but, in this context, they're investing in a handful of companies, and an even smaller number of really large exposures. Consequently, it's dangerous, and it's all correlated.

In practice, they're attempting to run away from risk but, in reality, they're running towards risk. They're not even doing what an index is supposed to do. The basic mission of the index was to avoid making a bet on individual securities; however, if you look at the exposures, you'll see that they are doing just that. It will not end well, for sure, and I don't think it will take too long.

Question 7

Would you please provide color on FRMO's third quarter unrealized investment losses?

Steven Bregman – President & Chief Financial Officer

If you look either at the balance sheet itself, on a line-by-line basis, or if you look on Page 13, Note 4, where it lists the individual funds, such as investments in Winland, South LaSalle, the Horizon Multi-Strategy Fund, or the Polestar Fund, you'll see that we predominantly have unrealized gains.

Murray Stahl – Chairman & Chief Executive Officer

If the question is asking about looking through the funds, security by security, we don't have much of that either. We have unrealized gains overall. If we had big unrealized losses, we would have realized those losses to offset the big gains that we had. There may be de minimis mark to market losses on a security here and there, but it's certainly nothing that's worthy of note.

Question 8

Please describe your strategic vision for the growth of Horizon Kinetics. Obviously, the success of Horizon Kinetics is quite important given FRMO's revenue stream.

Murray Stahl – Chairman & Chief Executive Officer

It's very simple. The vision is that we're not running away from equities. The idea of being a value investor will have its day. We're not moving away from that at all. But, if you want to get to the Promised Land, you must have other kinds of products. It might even be the occasional index.

There will be other investments. It might be in crypto-currencies. It might be in closed-end funds. It's likely to be in different kinds of hedge funds, for sure. It's a likely development. But there are all sorts of things we're working on.

To some degree, the character is changing even of the funds that we have in existence. In the future, they're going to be much more interesting, in my humble opinion, as a hedge fund, than they've been in the past, because the array of activities you can engage in if you move away from the current thrust of thinking is actually much more multifaceted than it has been in a very long time. I'm sure we'll come back to this question in the next quarter.

Question 9

Your firm has done a very nice job of chronicling the rise of indexation and how this trend has helped create a two-tiered market (i.e., stocks that are part of an index tend to be richly valued versus those that aren't). After listening to the latest earnings call from BlackRock, I can't help but think that the rise of indexation is still in its early innings. What scenario do you envisage that would impede the growth of indexation? On a related note, what catalysts do you see that could spark increased money flows into the more idiosyncratic investments that FRMO tends to own? Finally, it is increasingly apparent, to me anyway, that both equity and fixed income markets have morphed into "capital-light" business models. The result: high-frequency-trading across asset classes at a time when central banks play a disproportionately large role. How does this backdrop impact your expected return scenarios for potential investments?

Murray Stahl – Chairman & Chief Executive Officer

Okay, a lot of questions there. To a very small extent, we touched on this topic earlier, because we talked about indexation. To begin with, indexation is not in the early innings; indexation is in the late innings. It's possible that the game could go into extra innings, but here's the basic problem with indexation as I see it. Leaving aside the fee question, which is more of an orchestrator problem; it's a serious problem, which we already touched on. I don't think there's a lot of impetus to raise hundreds of billions of dollars for a handful of basis points. I don't believe it's going to happen. But I could be wrong.

Leaving that question aside, let's think about it from the point of view of the person who invests in an ETF. What sort of return do you think you can make? Let's ignore the danger of rising interest rates, high valuations, and even the danger of recession. The average recession comes at eight-year intervals. The last one came in 2008; this is 2016. It's something to bear in mind, but let's ignore that and many other risks and just say the following.

If you were to look at these big liquid companies, here's what you'd observe: a certain amount of their profits are paid out in the form of dividends, and the rest of the profits, on balance, are not invested in the companies but are invested in stock buybacks. As a generalization, there are exceptions, but the average company isn't investing in itself.

You have a further problem, because the S&P 500, if you want to use that, has, I think, 331 companies in it that have defined benefit plans. They need these plans to rise in market value because, if they don't rise in market value, even ignoring a decline, the companies must deposit more money in the funds. They have the money to do it, but it comes out of earnings. So, that's a problem.

If the S&P 500 companies are not investing their profits back into their businesses, here's what will happen. Let's say that we have 2% to 2.5% inflation, then they might get 2% to 2.5% earnings growth because of inflation. In addition, as an investor, you might get 2% to 2.5% in dividends. If stocks are trading at 25x earnings and they need to buy back a fair amount of stock, it's not going to move the needle that much. This is leaving aside the inevitable competitive factors, valuation factors, and recessionary factors. You're looking at maybe a 5% to 5.5% rate of return, if you catch it right.

Considering all the variability in the market, that's not an adequate rate of return. It's not realistic to expect a double-digit rate of return from equities. And, by the way, we didn't have a double-digit rate of return even in the last 30 years. Just think about all the actions governments around the world have taken, including fiscal stimulus, monetary stimulus, tax reduction, all these supportive policies, and look at the return. It's not double digits. It might be double digits from 1926, but it's not even double digits from the year 2000. It might be double digits from 2011 to the end of 2015. But look at the last 16-17 months. The return from 2011 hasn't been very robust either.

It's a lot of volatility to accept for a single-digit rate of return. You can debate what the rate of return is going to be, but it's going to be a single-digit rate of return. If you don't believe interest rates will rise, if money is cheap, you're a lot better off buying a 10-year Treasury, taking your 1.4% and leveraging it up fourfold. That's called risk parity, and a lot of people are doing it. Risk parity has a lot of money in it. It's a growing strategy, and it's competitive with indexation.

I don't want to leave anybody with the impression that indexation is in its early innings. It's a very mature strategy, and it has vulnerabilities, both from the orchestrator and the investor standpoint. I don't think it has a great future. Indexation is not going away, to be sure. It's going to be with us always, but it's going to be one strategy among many.

When indexation gets more money, two things happen. First, you're never going to get to 100%. As you gain more and more assets under management, the next thing that happens is you have less and less asset flow into indexation. If you look at ETF inflows, they're actually considerably lower than last year, because there's only so much money they're going to get.

If they're getting less flow, there's less for the high-frequency trader to track. And second, eventually, whatever's going to flow into it, once it's in, the marginal buyer, the active manager, becomes the person who values all the stocks. No matter how much money goes into indexation, at the end of the day, the active investor will win, because it's the active investor who will determine the value. It might be a very small active investment community; it might be 2% of all the assets under management. Everything might be in the index fund but, effectively, those index assets are going to be out of the market. There's not much doubt in my mind about the ultimate outcome.

Question 10

Regarding FRMO's investment in Horizon Kinetics LLC, I was under the impression that if performance fees fall, less income is accrued. Considering the decrease in value of FRMO's stake in HK, is it correct to assume that non-variable costs are greater than non-variable income?

Murray Stahl – Chairman & Chief Executive Officer

No, it's not correct to assume that. In other words, this is a polite way—thank you for being polite—of asking: "Is Horizon Kinetics not profitable?" Actually, it is quite profitable.

What basically happens is a couple of things. Number one, when we develop the earnings for Horizon Kinetics, we're making certain estimates. FRMO and the other shareholders' of Horizon Kinetics get a dividend. Depending on the timing of that dividend, some of it is designed to pay taxes. I should say in passing that, in a tax sense, Horizon Kinetics is a very inefficient asset, because we pay a lot of taxes. We'd like to figure out a way to do something about that, but we haven't yet figured it out. It's on our "To Do" list. Not easy, but hopefully not impossible, as a challenge.

Getting back to this question, we have a certain equity. At a certain month, in this case it's after November 30, we pay a dividend, sort of a true-up dividend. We may actually be paying out more income than for a certain period of time, like a quarter, or even a multi-month period of time. It depends on the calendar, because FRMO is on a May fiscal year and Horizon Kinetics is on a December fiscal. There could be a point in time, if you're measuring from Point A to Point B, when we actually, in that period of time, paid out more than 100% of the income. That's the reason that our investment would go down. But it's just the timing of when we decide to make a distribution for people who are on a calendar basis, as opposed to FRMO, which is on a May basis.

I think that's all the questions, and we may have exhausted your patience. We are very gratified by the many questions we received and encourage you to keep them coming. We will reprise this at the Annual Meeting of Shareholders that will be held on August 30. We thank everybody for listening and look forward to talking to you in a few months.

Operator

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

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