FRMO Corp.
Chairman's Letter

Dear Shareholders:

The most interesting oddity of the investment business, as opposed to other businesses, is that when the public loses interest in certain types of investments, these not infrequently become more alluring and ultimately more remunerative. In the world of ordinary commercial affairs, when the public loses interest in the products of a given enterprise, that enterprise must usually commit substantial sums of money to improve the product. The mere existence of public apathy can improve the product.

FRMO Corp., it will be recalled, has two dimensions. One of these is to invest its own capital. The investment climate for such in the aftermath of the events of 2008 has been quite favorable. Hence, as of May 2012, FRMO shareholders' equity achieved the level of $54 million. The other business is the so-called intellectual capital business that is represented by our interests in various investment products and a small interest in Horizon Kinetics LLC.

This latter set of businesses is almost entirely oriented around equity products. These various interests have not been immune to the flight of the investment public, both institutional and individual, from the world of equities. All of this is done in the name of volatility control. Of course, it is a natural human reaction to flee from danger or, in investment parlance, avoid risk. However, as of the date of this writing, the U.S. 10-year Treasury yields 1.4%. The yield to maturity on the iShares Barclays Aggregate Bond Index is 1.29%. Say what you will about it, but a 10-year Treasury yielding 1.5% is anything but risk-free. If, one year from now, that Treasury were to yield merely 3.5%, the holder of that note would experience a price decline of 15%, equivalent to a loss that is 10x the magnitude of the expected return. Even equity investors don't find that sort of offer appealing.

Anyone who cares to study the figures on mutual fund flows released by the Investment Company Institute will clearly see there has been a continual and inexorable flow of money away from equities and towards bonds. In fact, equity flows have been vastly negative every month since May 2011, with the exception of a nearly $1.4 billion inflow to equities in February 2012. A normal monthly inflow into bond funds might be perhaps $20 billion. Bond flows have been positive every month since February 2011, with the exception of nearly $4.3 billion of outflow in August 2011.

Moreover, there has been a concurrent shift even within the context of equities, with active portfolio management being massively displaced by the movement toward indexation. One form of indexation is the Exchange Traded Fund, commonly known as the ETF. The following table, based on data to be found in the Investment Company Institute Fact Book, will readily provide an explanation of the unfortunate circumstance in which active managers find themselves:

ETF Assets Under Management 2001 – 2011	
2001	$83 billion
2002	102
2003	151
2004	228
2005	301
2006	423
2007	608
2008	531
2009	777
2010	992
2011	1,048

Source: Investment Company Institute Fact Book

It should therefore not be surprising to learn that the Horizon Kinetics equities business has endured outflows as well. In any case, it remains solidly profitable. Measuring from this point forward, equities need not even appreciate to provide a return superior to that of bonds, since the dividend yield on a typical equity portfolio is greater than the yield to maturity of the iShares Barclays Aggregate Bond Index.

Viewed from the perspective of an active manager, though, this apparently problematic circumstance has created, in the opinion of the management of FRMO, a number of enormous opportunities. This, incidentally, occurs whenever the institutionalization of investments reduces the practice to the mere application of a formula. The space available in a shareholder letter is inadequate to properly address this topic. However, more data and commentary on this very interesting and important subject is available on the FRMO website in the Research Section.

In any event, two examples of the situation created by formulaic index investing follow. First, let us consider the case of the co-called owner-operators. Owner-operator companies are those controlled by a significant, typically the largest, shareholder. This is a person with a great deal, perhaps most, of their personal capital at risk in that business. This may be contrasted with the vantage point of the conventional CEO, who might be termed an agent operator, whose wealth is typically determined by a compensation package that is often independent of the long-term value of the shares. Consequently, owner-operators have quite different attitudes towards risk and opportunity than agent operators and tend to make much different business decisions over time.

Businesses managed by their founders and/or largest shareholders tend to have much more liquid balance sheets, are more opportunistic and exhibit remarkably higher long-term results. Among the most easily recognized historical examples are the likes of Wal-Mart (Sam Walton), Intel (Gordon Moore and Andy Grove), and Microsoft (Bill Gates), although they have not been owner-operated for some time. Well known companies that still qualify are Berkshire Hathaway, Starbucks and, until late last

year, Apple. Although these are anecdotal examples, the comprehensive historical statistics are irrefutable and such companies historically sold at reasonably high valuations that reflected the high regard in which they were held.

In recent years, though, something odd has occurred. Coincident with the 2008/09 financial crisis and the ensuing flow of funds from individually selected stocks into index based funds, owner-operator companies have come to trade at unprecedentedly low valuations. It is not unusual to find such companies, with long histories of superior growth and consistent management, trading at discounts to liquidation value or at single-digit P/E ratios. One of the remarkable aspects of this valuation shift is that these were among the few companies that accomplished, during the past several years of crisis, precisely what an investor would desire. If one may broadly characterize, they entered the financial crisis with liquid balance sheets and avoided the funding and liquidity threats faced by many other companies; they thereupon took advantage of the plentiful business disruptions to acquire competitors or additional assets at deep discounts, and even began to repurchase their own shares to very beneficial anti-dilutive effect. This all took place while the average company, as much commented upon in the press, did precisely the opposite: husbanding cash or selling assets. The result has been that owner-operator companies continued to expand their essential measure of shareholder wealth – book value per share – at quite satisfactory rates.

An explanation for this paradoxical phenomenon may be found in the substitution of individual stock selection for the perceived safety of an index or basket of stocks, as in the form of an ETF. However, the manufacturers of ETFs do not work pro bono. They operate a business, and the average management fee for that business is quite low. It is necessary, therefore, to attract quite a lot of assets in order to break even. Accordingly, they construct the rule set that defines their indices (and the associated ETF) in a manner that doesn't inadvertently limit their ability to gather assets. For instance, if a given index, let's say an index of oil and natural gas pipeline companies, is intended to be equally weighted among 30 companies, but the smallest one has a very small market capitalization, then the magnitude of assets the ETF can accept will be limited. So, to avoid curtailing their asset gathering capability, the ETF manufacturer will alter the rule-set, which practically speaking is both an exclusion as well as an inclusion system, to exclude that smaller-capitalization company.

It happens that owner-operator companies, due to their often significant inside ownership, have fewer shares in public hands, such that they are effectively smaller-capitalization companies from the perspective of public float or readily tradable shares. Accordingly, they tend to be excluded from indices (and they tend to fall under other rule-based exclusion criteria as well). One can see how, due to purely formulaic or systematized application of investment rules, as opposed to direct analysis and explicit decision making, perhaps one of the most qualitatively attractive segments of the stock market has become effectively invisible—and, quantitatively, enormously attractive. That is, if one sees the equity market through the lens of indices and ETFs, companies such as owner-operators are largely outside the average investor's focal range.

Another example of the dysfunctional nature of index investing is the relationship of many of the largest American companies, via their pension funds, to the S&P 500. If one were to look at the 100 U.S. public

companies with the largest defined benefit pension plans[1], one would find the likes of Exxon Mobil, General Electric, Pepsi, Verizon and UPS. As of the end of 2011, using these largest 100 as a proxy, American companies recorded perhaps the largest underfunded status ever, certainly within the past dozen years, both in dollar and percentage terms. And this follows a helpful three years of double-digit annualized returns on their plan assets.

Moreover, there is much reason to expect this position to worsen. The discount rates they use to determine the present value of all their future estimated pension obligations is about 3 times higher, at an average 4.8%, than it should be, since we know the average investment grade bond yield today to be about 1.3%. This means that the obligations are actually far larger than currently presented in these companies' financial statements. Moreover, these pension plans, on average, still presume to earn almost 8% on their plan assets. Yet, over 40% of the plan assets are invested in bonds. Assuming, as one must, that 40% of these pension plan assets will earn 1.3% at best, then those bond portfolios, all else equal, can contribute only 0.5% to the return of the entire plan assets. This leaves the remaining 60%, most of which is invested in equities, to produce the balance of the 8% expected return, which means the balance must produce about a 13% return every year.

First, one is hard pressed to suggest that this reality will come to pass, so that one should expect much larger funding deficits in the coming years and, it follows, much larger contributions to those pension plans, which in turn must detract from shareholder earnings and earnings growth. That pending reality, though, is less interesting than this one: that these companies, by dint of their investment philosophy and practice, place the major portion of their equity assets in the S&P 500 (and other indices representing essentially the same, largest companies in the U.S.), in order to attempt to earn the highest risk-adjusted expected returns. Yet the S&P 500 to a significant degree is composed of the set of companies with the largest pension plans, which are problematic as described above – these companies are investing in themselves for future returns to restore their pension plans, even as they themselves are problematic because of their pension plans. But this is their formulaic process, and the tools by which this process is measured and implemented are these self-same indices.

As to FRMO's future, there are two new products that we believe will be important contributors to future earnings. One relates to an agreement between Horizon Kinetics and Virtus Investment Partners, Inc. Virtus is a publicly traded investment firm (ticker VRTS) that managed $21 billion of assets as of June 30, 2012. It has ownership interests in Duff & Phelps, Kayne Anderson Rudnick and Zweig Advisers, among other managers. On June 13, 2012, Horizon Kinetics and Virtus announced that Virtus will introduce a new open-end mutual fund, to be known as the Virtus Wealth Masters Fund. This fund will be managed by Horizon Kinetics and will track the Horizon Kinetics ISE Wealth Index (ticker RCH).

The index, which has its origins in the owner-operator theme discussed earlier in this letter, is comprised of publicly held companies that are managed by some of the wealthiest individuals in the U.S. It is intended to not merely outperform the average equity, but to bring some rational, reliable basis for equity investing to the general public, which is now faced with a dizzying array of index/ETF choices,

[1] From the Milliman 2012 Pension Funding Study

some of them dysfunctional, and which invite excessive turnover and the unfortunate consequences of such behavior. It is hoped that an index of companies managed by individuals who have a substantial quantity of their own capital at risk in those shares, and who are the least likely to sell their shares casually or inopportunely (or at all), might induce some investors to feel greater comfort in their investment, likewise take a longer-term view, and thus benefit from the long-term compounding of intrinsic value that is the rational basis for equity investing. In its best expression, the Horizon Kinetics ISE Wealth Index can represent a form of democratization of indexation for the individual investor.

Such grand thoughts aside, there is great potential for such a fund, if successful, to accrue a very large quantity of assets and, through FRMO's interest in Horizon Kinetics, the associated management fees. The nature of the agreement with Virtus is such that there should be no meaningful expense associated with the management fees that redound to Horizon Kinetics, so the profitability of this venture could be quite high.

The second product is a new and perhaps unique investment strategy introduced this month at Horizon Kinetics. It is based almost exclusively on short-sale positions in a variety of instruments, is designed to exhibit very low volatility and to provide an expected return of fairly high order, and with no leverage. Clearly, this addresses a different and more exclusive market than the Virtus Wealth Masters Fund, but as the strategy is being enacted in a hedge fund form, the fee structure is reasonably high. Relatively modest fund raising success in this fund, known as the Polestar Fund Class S Interest, even to a degree that would be considered unsuccessful for a mutual fund such as the Virtus Wealth Masters Fund, could have a meaningfully positive impact upon the earnings of our Horizon Kinetics interest.

As to our investment in Horizon Kinetics, this is presently just less than a 0.5% interest. While seemingly diminutive, it applies to a company with a not insubstantial asset base, which was approximately $6.7 billion as of June 30, 2012. Also, we recently agreed to sell one of FRMO's revenue contracts to Horizon Kinetics. This would be in exchange for additional shares of Horizon Kinetics, thus increasing our interest. Horizon Kinetics embodies a variety of avenues for expansion, not merely through the great operational leverage in the asset management business when share prices rise, but most particularly through a series of new and developing investment strategies. These all seek to respond to some of the most pressing, even acute, investment needs of the day, such as for strategies that provide predictive as opposed to passive attributes (like the Virtus Wealth Masters Fund), or reduced equity volatility, or a rational yield/volatility balance such that one can actually earn a reasonable income.

We believe the future of FRMO holds as much promise as it ever has.

July 30, 2012

Murray Stahl, Chairman of the Board and
Chief Executive Officer