FRMO Corp. Q3 2014 Conference Call
Thursday, April 17, 2014

Operator

Good afternoon everyone and welcome to the FRMO Corp. 2014 third quarter conference call. As a reminder, this call is being recorded. At this time, I would like to turn the conference over to Therese Byars. Please go ahead.

Thérèse Byars – Corporate Secretary

Thank you, Yolanda. 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 FRMO Corp.'s website at www.frmocorp.com.

Today's discussion will be led by Murray Stahl, Chairman and Chief Executive Officer of FRMO Corp., and Steven Bregman, President and Chief Financial Officer. They will review key points related to the third quarter earnings. Once they complete their remarks, we will move to questions. A summary transcript of this call will be posted on the FRMO website. With that, I'll turn the discussion over to Steven Bregman.

Steven Bregman – President & Chief Financial Officer

Thank you, Ms. Byars. Good afternoon. I'm going to cover a few items on the income statement and balance sheet. And then Murray can talk about undoubtedly more interesting or strategic items.

One will note, on the revenue line for the three-month period, and on the Net Income line, that results for the third quarter of 2014 appear to be lower than for 2013. But if you go one row or two lower, you'll see that the Comprehensive Income is actually quite a bit higher. And that relates to the difference, for instance, between the fact that realized gains, such as might be taken in some of the private fund interests that FRMO owns, would be recorded under realized gains and losses. But the unrealized appreciation might not be, and that would show in Other Comprehensive Income. So, as becomes apparent, since we have a fair amount of assets managed that way, that one really has to look at the total Income Statement, not just what is called Net Income, but Comprehensive Income as well.

As to the balance sheet, I will review a couple of items I seem to like to review as we do this. Under the Liabilities section, you'll see a row for Securities Sold, Not Yet Purchased. These are a certain kind of permanent short positions that Mr. Stahl maintains in the accounts he manages for FRMO Corp. You'll see that the basis in the statement for February 2014 is $2.1 million. It is actually lower than for May 2013. Yet, the proceeds for the February period are actually higher, at $5.6 million versus a $2.1 million basis. There is an unrealized gain there of $3.5 million. The unrealized gain for the prior period, for May, is only $2.1 million. The increase in the unrealized gain on those permanent short positions over the nine months was $1.3 million.

I don’t know if you think that is large or small, but one way to look at it on a proportional basis is that $2.3-odd million of basis at the end of May was about a little over 2.5% of the book value of FRMO Corp. But it added about two percentage points to the entire book value of FRMO Corp. during the nine months, or on an annualized basis, let’s say. That is kind of efficient for a position of that size.

Then last, if you look at the shareholders’ equity of $91 million, I’d like to add to it the deferred taxes, which also keep growing. They should continue to grow, so long as we don’t close various positions we have. It is a sort of permanent and growing number, the taxes we actually aren’t paying. If I add that $12.8 million or so to our book value, I think our effective economic book value is more like $104 million. I dare say, if we went to some agent to try to borrow funds, they would look at our income production; they would look at our assets; they would look at any hard liabilities we have. I don’t think they would hold those deferred tax liabilities against us, which is why I think it is economically appropriate to think of it as $104 million.

There is an item that if I don’t cover, I’m sure I’ll be asked about, which is that our taxes for the quarter seem to be inordinately high, ‘inordinately high’ meaning that Provision for Income Taxes of $1.4 million on Income from Operations of $1.7 million looks something like an 80%-plus tax rate. It is due pretty much entirely to the timing of when the accountants have to make, or are able to make, certain correcting adjustments, and they fell into the three-month period.

Two items of note are ‘permanent differences’ and ‘prior-year true-up.’ The item we call it ‘prior-year true-up’ was $300,000-some-odd for the three-month period, and it was exactly the same figure for the nine-month period. That is primarily a true-up relative to accrued amounts that the accountants estimate versus the actual amounts, such as might be related to hedge fund activity. There is another, which has to do with ‘permanent differences,’ which also has to do with differences between K-1 items and book income, which was also a few hundred thousand dollars for the quarter, and was almost nonexistent for the nine months.

One way to think about the two sets of numbers to see that they work out in a consistent basis is, if I were to remove those two true-up type of accounting entries for the quarter, the tax rate would be something like 46%. The tax rate that appears on the statement for the nine months was all of 48%. So, this is really an issue of timing.

Part of the problem the accountants have is that we have a fair amount of assets in these private funds and, obviously, the results in terms of performance in the marketplace can’t be predicted. It would be great if they could be predicted. We’ve got about in excess of $20 million of such assets. There are issues of when gains are taken or when they’re simply unrealized. There is the issue of incentive fees and when those crystallize. Last year in particular, the two major private funds in which FRMO has limited partner interests were up about 50%. The accountants really can’t account for that in advance and, when they get the final figures, they have to make the adjusting entries. So, in any event, don't be alarmed by an apparent 82% tax rate in the quarter.

The last item, which is tiny in fact but may be more significant in character, is a new line item in our income statement. It did not make it into our published financial results, but we'll get it in next time, unless the accountants have some objection. The item is an $800 bit of income for this most recent quarter and another one for the prior quarter. For the six months, there is $1,600 of income showing under an account we call 'Board and Other External Fees.' Maybe this will lead into one of Murray's discussions. Those relate to directors' fees that actually are due Mr. Stahl for his being a member of the board of the Minneapolis Grain Exchange.

With exchanges, a corporation very often can't actually own seats or, in this case, memberships. So, even though we might think of FRMO, for instance, as owning memberships, they must be held in an individual's name. So, I believe that the Minneapolis Grain Exchange memberships are actually in Mr. Stahl's name. As a member of the board, he does get emoluments, as they call it. But he has disclaimed those and prefers that and believes that they should accrue, at least in part, to the benefit of FRMO Corp. So, I hope we'll see that line item actually on the published financial statements next time. And now I'll turn the discussion over to Murray.

Murray Stahl – Chairman & Chief Executive Officer

Thank you everyone for attending today. Let me just say one thing about the Minneapolis Grain Exchange. It is just—I don't want to correct you, Steve, but I do want to make it clear I don't own personally any memberships on the Minneapolis Grain Exchange. FRMO invests in a limited partnership that owns the memberships. As Steve pointed out, each membership must have the name of an individual associated with it, so if a membership is owned by an entity, that entity is the record *owner*, and a designated individual is the record *holder*. So, for the limited partnership that owns the memberships, the fund is the record owner and I am the record holder. FRMO participates in the exchange by being a subscriber in the limited partnership. The fund definitely has the ownership, not me, although I have some money in the fund as well.

In any event, before I go on to some strategic issues, I want to point out a few items on the balance sheet that are interesting to me. I like to compare year-over-year, so February 2014 to February 2013. In February 2014, cash is $26.7 million and, a year ago, February 2013, it was $21.1 million. That is a big increase in cash. Accounts Receivable is $1.6 million and, a year ago, it was $342,000. That is a big increase as well. Investments now are $58.1 million, while one year ago they were $45.9 million. So, we spent some money and, of course, the market value of the assets appreciated.

In the Securities Sold, Not Yet Purchased category—which technically is a liability, although we look at it a little bit differently—in February 2014, we have $5.6 million of proceeds from securities sold short, with a market value of $2.1 million. A year ago, we had $4.6 million of proceeds. And we had a $2.2 million, closer to $2.3 million, market value. So, we sold short roughly $1 million worth of securities, and the market value declined by that $1 million and another $140,000 on top of that.

If you look at the denominator, which of course is the market value of the securities sold short, on February 2013, which is a little bit less than $2.3 million, that is actually a very big rate of return, which actually leads me into strategic items, which is why I bring it up. There is no magic there. All we're doing is selling short various of the so-called path-dependent—or dysfunctional as I call them—indexes and exchange traded funds. The academic term is 'path-dependent,' which I'll define momentarily, but the word I us is 'dysfunctional.'

In the academic literature, path-dependent means that, sooner or later, no one can tell exactly when, those securities will gravitate towards a price of zero. It is much like Zeno's Paradox: it never really gets to zero but is goes down 99.99999%, which is really very bizarre. The reason I bring it up is not to show we made any money, but for strategic reasons.

I can talk about some of the investments we're making. The problem with the modern-day investment world, viewed through the lens of modern portfolio theory, is that it has an unspoken presumption. The unspoken presumption is that people are not really satisfied with the securities—I mean all the securities, the aggregation of securities, the tens of thousands of securities that exist in the world—they're not really satisfied with them. They have too much volatility; they have too much risk.

What people seek to do is, by combining them in different ways, meaning different forms of diversification and/or selling short and/or inclusion of different asset classes, et cetera, et cetera, they can change the risk/reward profile of the securities in some way to make them less volatile. Because basically, in sum, they want less risk. They can't get less risk. They're trying to achieve less risk, even at the cost of a lower rate of return.

The objective itself is very reasonable—you might even say it is noble—but the methodology I don't think is appropriate. Because the real question is if you're creating a portfolio, however it is you control the risk and however it is you diversify it, by basically either hedging or removing from the portfolio the high-risk elements, somebody, at the end of the day, has to take the risk. So, the critical question is: What is that someone—you might call that someone a speculator—what is that someone going to charge, not just in absolute numbers, but as a percent of the return you might get in a security?

For example, say you own Security A and you expect a 10% per annum rate of return, but you don't want to take the risk associated with that, and you buy a put option or you sell another security short against it. The question really is—since you're really trying to put the losses, if they occur, on someone else's books—what are they going to charge you? Because, when you do that, they're effectively going to be long that security, even though in book entry form you're long that security.

What we believe is happening in the world is that the clearing price for taking that risk is very high, because virtually everybody wants to sell, and nobody wants to buy. Over the last year or so, we've been creating different instruments to take advantage of the other side. One product is the Virtus Wealth Masters Fund, which now, as of the most recent reckoning, has about $121 million in it. That is one of those instruments.

We've talked about it before, so I won't belabor it. Essentially, we believe that for companies that are controlled by people who have virtually all of their net worth in that one security, those people are taking a lot of risk. In turn, as investors try—because it logically follows in the way they build indices—to eliminate, or at least underweight, those securities in the portfolio, someone has to be long those securities. The question is: what are you going to get if you're willing to take the risk?

I think the results of the Virtus Wealth Masters Fund speak for themselves, and I'm very enthusiastic about it. I talked about it last time. I don't want to go into too much detail about it now unless it comes up in the Q&A, because I want to move on to other interesting items, but I have very high hopes for that fund.

In a couple of days, I think May 1 exactly, we're starting another one of these instruments that is going to be in partnership form. It is going to be another intriguing way, in my reckoning, of investing in emerging markets. I don't think anybody is doing anything like it. I can't talk a lot about it, because it is something that is sold only to accredited investors, but I personally think it is kind of neat. One day maybe I'll be in a position to tell you more about it, but that is starting very shortly.

The thematic structure is really the same as Virtus Wealth Masters. There is some subset of securities in the universe of securities in the world that are being systemically excluded from indices for a variety of reasons, and there are interesting characteristics that you can capture from being long that subset.

We've also been making some investments over the past year, and I want to talk a little about those. One that we've been gradually increasing our ownership in, via the mechanism of a Horizon Kinetics private fund, is the Minneapolis Grain Exchange. I don't know if you follow the Minneapolis Grain Exchange but, in the last four or five months, you'll see that the volume of wheat has gone up a lot. There are many reasons for that, one being the removal of government control from the Canadian wheat market.

Historically, the Canadian wheat farmers didn't hedge their wheat product. Rather, they used the Canada Wheat Board. Years ago, there were also the Saskatchewan Wheat Pool and the Alberta Wheat Pool. They would buy the entire wheat crop of Canada, and then sell it on the market, but they would negotiate as a block, with the idea of giving the farmers a better deal. For various and sundry reasons we needn't go into, the Canadian government and the provinces are out of that business, which means they are out of the business of basically insulating the Canadian farmers from market risk. Now, to the degree that the Canadian farmers want to be insulated from market risk, they have to get their own hedges.

I think that is part of the reason for the success of the Minneapolis Grain Exchange. If you follow the price of seats, they are worth more. But, even ignoring that, it is an exchange that has the right to engage in many activities and one day it may be doing that. Even the building of the Minneapolis Grain Exchange is in a neighborhood scheduled for a lot of urban renewal in the next 33 months. I can only presume that 33 months from now it is going to be in a lot better circumstance. So, that is one set of investments.

Another is that not very many days ago, we announced that we took a big interest in the Bermuda Stock Exchange. Again, we can't promise you anything. However, if we are able to accomplish something like a new type of security or a new type of fund to trade on that exchange, the following arithmetic attributes would apply. The Bermuda Stock Exchange, at the valuation that we transacted in it, has a market capitalization of all of $6 million.

Someone once asked me, "What is the point of going after 'the peewee exchanges'?" My answer is that if you create something, the return you get, to some degree, is a function of the denominator, in other words, how much money you need to invest in it. As to the numerator, the product is going to do whatever it is going to do; it would do the same thing if it were part of a bigger exchange. However, if the denominator is small enough—the idea is to get the maximum operating leverage by having the minimal investment necessary to secure a place in that instrumentality.

Another point that you might not realize is that Bermuda has no corporate income tax. Again, we can't promise anything, but in the event that they are able to accomplish something, the profits would accrue to the Bermuda Stock Exchange, the corporation, and would basically accrue tax-free. That is a way of meaningfully increasing your after-tax rate of return.

Strategically, we're looking at other opportunities, not necessarily in exchanges, but to expand within the context of financial services, although in one sense an exchange is broader than financial services because it involves processing and technology. It is not merely financial services. We're looking to expand in that regard.

I wouldn't necessarily conclude that the next investment is going to be an exchange, but it all has the same common feature that we're not investing huge amounts of capital. We're investing, not for a guarantee, of course, but for the opportunity, the possibility if you like, that there is a lot of upside gearing, so to speak, achievable if the right things fall into place. We're not betting the company on any individual investment, and we don't intend to drain our cash. Even with everything we did over the last year, we still managed to increase our cash.

We don't need to have $1 billion of cash on the balance sheet or anything like that. We'd like to make our cash work for us, but in no sense are we interested in deteriorating the balance sheet whatsoever. I like the balance sheet we have; I think it is a fabulous balance sheet. We'd like to make it bigger and we'd like to make it better. There will be a diversity of investments, and they'll have the common theme of an idea. Intellectual capital, given the scale of investment, can have a lot of operational gearing.

I'll stop there and give callers the opportunity to ask us questions about any points that we didn't clarify or that we didn't address at all. I didn't say much about how Horizon Kinetics is doing, and we'll talk about that maybe in the Q&A if someone wants to bring it up. At this point I'd like to open it up for questions.

Questioner 1

Hi. I have a quick question. Could you provide some background on why FRMO is trading on the OTC for now? Are there any plans to uplist again? Thank you.

Steven Bregman – President & Chief Financial Officer

By 'uplist,' I presume you mean to list on the New York Stock Exchange. We've thought about it periodically. Sometimes we ask ourselves if we should, and we examine the benefits and perhaps the merits of listing on the New York Stock Exchange. We might well do it in the future—maybe it is a good idea. However, so far, we've decided that the balance of factors doesn't suggest that we should. There is certainly an explicit cost in terms of accounting requirements and Sarbanes-Oxley requirements and so forth. It is not clear that a company of our size would get more attention or more volume, given how people treat the marketplace now and what they're looking for. OTC Markets itself seems to be gaining more credibility and volume and so forth. They have a reasonably rigorous qualification process for filing statements and other financial items.

At the moment, I'm satisfied. I'm certainly willing to hear any specific suggestions as to the benefits of switching, or any complaints about how our information is presented or made available.

Murray Stahl – Chairman & Chief Executive Officer

If I could just add to that answer: As you know, there is a certain financial cost. It is not merely effort—we're willing to make the effort, but I refer to a certain financial cost measured in dollars. The issue for us is, how many dollars of our earnings, at this stage, do we need to expend? Phrased alternatively, what percent of our earnings do we need to expend to go to a higher level, to either list on the New York Stock Exchange or NASDAQ? It is not a small expense.

In that context, other questions arise. If we were to expense that money, what are we getting as a corporation in return? What are our shareholders getting as a corporation in return? We would like to revisit that question when and if our earnings are at a higher level, so that the expense, which doesn't rise proportionally with our success, becomes less of the company's earnings.

We certainly revisit this question every quarter. I think it is discussed regularly at board meetings. Obviously at some point, if we're sufficiently successful, it will make sense to uplist, as you say. We revisit that question about every 90 days, and we'll continue to do so.

Questioner 1

The reason we were thinking about the possibility of uplisting for FRMO is because, concerning the current valuation of your company, is uplisting a possible way to use the current stock price as a sort of currency for future acquisitions?

Murray Stahl – Chairman & Chief Executive Officer

To use the stock as a currency for future acquisitions, let me put it this way: you know what I own of the company. At the moment, given our valuation, I'm not in the mood to dilute myself at all, not even a hundredth of a basis point. I just don't want to do it. Maybe that tells you something about what I think of the company, but I don't wish to use it as a currency at the current stock price.

I'm very confident. I think we have a lot of good things coming. No guarantee there but, if it was a question of that, then it is really also a sign of what we think of our stock, and we think highly of our stock at the moment.

Steven Bregman – President & Chief Financial Officer

I'll say as well the point you raise is a very interesting one. We're going to have many discussions about it. In fact, we do all the time, from slightly different vantage points, with clients and due diligence teams and research subscribers. There is a presumption—and, in a prior decade, it might have had more merit—that, if you've got a large enough market capitalization, and you list on the New York Stock Exchange or NASDAQ as opposed to some lesser shadow exchange, that there would be more attention paid to your security. More people would see it; you'd get better trading, more volume, a higher multiple.

But in today's world in particular, it seems like it should happen, but it clearly doesn't. There are a couple of minor elements I'll talk to. One is that although we have a multi-hundred-million-dollar market capitalization now, in terms of the liquidity that is so important to the marketplace and whether a stock fits into an index or not, whether it can be purchased en masse or traded with sufficient rapidity by a buyer, FRMO's float is only some tens of millions of dollars. In terms of what is actionable, it is effectively a microcap.

As you know, part of the business of Horizon Kinetics is locating undervalued securities that can be purchased, by and large, by institutional investors, those who are our subscribers, or to invest in on behalf of our clients. We find companies in the billion and multibillion-dollar range that are trading at deep, abysmal discounts to their book value or intrinsic value, or at excessively low multiples of their earnings. Some might be more controversial or less, but our portfolios are populated with them. We think they're fine companies.

Based on those examples, it is not clear that even if we could multiply our market capitalization by 10 that anybody would be interested in it sufficiently on that basis alone, not on the basis of what we might do in the future. People begin to suspect there is something else going on, there is something better going on; they want to pay for that. But it is not clear to me, if our market cap were 10x higher today, that we would trade at the multiple that we think we should trade. And I thank you for thinking we should, too.

One of the last things Murray mentioned in his formal presentation was how much cash we have on the balance sheet. We have $100-plus million in assets, and $27 million of that is cash, which effectively, as you must know, is earning zero. We also have $58 million of investments, $47 million as of May 31, 2013, and a lot of that is in fixed income securities. In fact, the bulk of it is.

I made a little calculation just now that if you add up our dividend and interest income—so, we have, basically, a very liquid balance sheet, and it is in fixed income and cash. The fixed income market, by and large, today earns about an average yield of less than 3%. If you add up our dividends and interest income for the quarter and multiply it by four, and if you take the increase in unrealized gains on the short positions Murray discussed, and annualize that, we actually earned about 5% on an annual basis. We're earning about 5% on our current assets, which is not bad for a portfolio comprised of cash and bonds.

Murray Stahl – Chairman & Chief Executive Officer

At the moment, if we were to engage in an acquisition for cash, remember the constraint is that we're not betting the company on any individual acquisition. We have $107 million of balance sheet assets. We don't really want to make a $107 million acquisition, even if we could do it for stock, because that is sort of betting the company, or at least betting a lot of it, on one acquisition, and we'd rather not do that.

It maybe gives you a window as to how aggressive we want to be about this question of using the stock as a currency. I think we have all the assets we need to do what we need to do, at least for the foreseeable future. And let's show the world that we did some good things for the shareholders. I don't know if dilution is such a great thing.

Questioner 2

Could you give a brief update on assets under management with Horizon Kinetics and what you think is noteworthy as far as some of the new products?

Steven Bregman – President & Chief Financial Officer

By the way, you can find information on the Horizon Kinetics website regarding that company's assets under management, either directly or via the FRMO website, which has a link to the Horizon Kinetics website.

I'm just going to read to you from the slides we have up there. Firm-wide assets as of March 31 were $9.7 billion, up from $8.1 billion at March of 2013. By and large, the mix of assets has, I would say, become more profitable. There is something called Intermediary Business, which is, in common terminology, a WRAP business, which is a very low-margin business. That really has not expanded much in terms of asset flows, whereas other businesses have.

An important part of the mix is the smallest category, called Alternative Investments, which is about $0.7 billion. In the last few quarters, that Alternative Investments segment has increased by a couple hundred million dollars. It is not this simple by any means, certainly not, but if one were to grossly simplify, just for the thought process, and assume that those alternative investments, which are for the most part partnerships and hedge funds, were just to increase a couple hundred million dollars over the course of a few quarters, here's what could happen. If those were to earn, let us say, a gross return of 20%, and if—and it is not the case—and if the average incentive fee were 20%—some are quite a bit lower—but that would be $8 million of incentive fees. Relative to even the entirety of the Horizon Kinetics earning stream, that is very significant.

The best way to judge a lot of our strategic efforts or new products is not necessarily by the amount of assets but by the type of assets. The Virtus Wealth Masters Fund, for instance, certainly is not a hedge fund. We get a fixed fee base on it. But we're not responsible for marketing it. We don't have any meaningful operational expense with regard to it. The scale at which it can operate is certainly not limitless but, relative to our current size, it is virtually so.

Anything that FRMO Corp. might be engaged in with exchanges, which is all merely creative thought at the present time, would be interesting. There are various products related to providing reasonable yields—I mean, in an absolute sense, reasonable yields—with limited volatility that seem to be making positive impressions upon various clients, who are investing more money in those. The market for that is simply enormous. There really is an absence of yield in the marketplace today, and there are a lot more assets available for investing there than in equities.

A lot of our products are at the beginning stages. They've been out for months; they've been out for a year or so; they're just developing track records. But we find they're getting better and better audiences as we introduce people to them. In success mode, if several of these begin to build at the same time in the next year or two, then the Horizon Kinetics profit picture could be much bigger than it is now. But we'll see.

Murray Stahl – Chairman & Chief Executive Officer

Another way of looking at the whole Horizon Kinetics picture is to take the $9.7 billion of assets under management and divide it into three categories. One you can say is direct institution, where some institution like a pension fund gives us money to run. That was never really a big part of our business, and it still isn't a big part of our business. It really doesn't grow, and I don't think that is going to be a huge part of our business in the future.

Then there is the intermediary institutional business, which is—there are WRAP programs and dual contract programs, and we get an allocation of some larger institution. That is fine, but the institutions are constantly diversifying, and you're constantly fighting with hundreds—literally hundreds, maybe even thousands—of money managers for allocation. So, it is a hard business to be in.

Then there is the business that we've always shined in, which we devote a lot of effort to, which is direct individual business, the private clients business, which is our own background. That business is much more stable, for reasons we can talk about. It is higher-margin, but it is also less volatile. It is more diversified, because you're dealing in thousands of clients as opposed to a handful of institutions. While it feels wonderful that a big institution gives you a $250 million mandate, of course, the big institution can take away the $250 million mandate, which is why the money management business as such is always so problematic for so many people. The individual business continues to grow.

And then there is a fourth way you can look at it. There are certain types of products that have caught the fancy—I don't know how else to say it—of the investment community. I'll describe some of them. One we mentioned, which is the Virtus Wealth Masters Fund, which I have high hopes for.

Another one, which you might not focus on, is the Kinetics Small-Cap Mutual Fund, which is a traditional small-cap mutual fund. It turns out that in the United States—maybe even the world—there is a dearth, an insufficiency, of small-cap managers that have a good track record. That fund has been garnering a great many assets under management and growing fairly rapidly off a very small base, which is very important. It was a small base to start with and it is now over $400 million in size.

If you have a small mutual fund, let's say a $50 million mutual fund, you can't expect to get $50 million of new money, because the new money is too large a proportion of the money that was already in there. But the more money you get, the more money you have, and the more money you can obtain. So, it is scalable in that sense.

Another one that you're even less likely to focus on is the Kinetics Multi-Disciplinary Fund, which a lot of people don't focus on, because you wouldn't associate us with a fund of that type. The idea behind the fund is to use a combination of conventional bonds and way out-of-the-money put options that are not very volatile to create an interest income stream, or a dividend yield on the fund, if you like, that is above the level you could otherwise get by investing in the bond market as such, and do it with very low volatility.

That fund has now about $108 million in assets under management. It wasn't long ago that it was much less. I don't remember what the number was two or three years ago, but I do recall that in June of 2011, the fund had $1.8 million. I might be off on that by a little bit, but even if I'm off by $1 or $2 million—which, on that level, is an order of magnitude—you see the difference. This fund seems to have found an audience.

That is the whole idea: to find products that make sense for people and deal where we can with the wealthy individuals, because I think it is a more stable marketplace for us in Horizon Kinetics. There are other things we might do in different venues that are more institutionally oriented. These sorts of products are designed for individuals. So, that is sort of an overview of what is happening at Horizon Kinetics. It keeps innovating, and it has been successful.

Questioner 2

Was that the former Water Fund?

Murray Stahl – Chairman & Chief Executive Officer

The former Water Fund is not the Kinetics Multi-Disciplinary Fund. When the Kinetics Multi-Disciplinary Fund started in 2008—not a great time, by the way, to launch a fund, it went through, I guess, the same travails every fund goes through in its first couple years, especially if the first couple years are those that we saw in the marketplace in that era.

What used to be the Water Fund is now the Kinetics Alternative Income Fund. Someone approached us with the idea of a water fund under the Kinetics label; basically, somebody was managing the fund and just using our operational infrastructure within the context of our mutual fund group.

Then, at some point, they decided they didn't want to manage it anymore. We didn't want to run a water fund, so the options were: close the fund and just give the money back. By the way, the fund didn't have a lot of money in it. As I recall, it had $10-ish million in it. The options were: give the money back or change the mandate. We opted for the latter, to change the mandate.

About one year and four months ago, shareholders agreed to change the mandate. That fund became the Kinetics Alternative Income Fund, which is designed to be the lower-risk version—also lower return—of the Kinetics Multi-Disciplinary Fund. The idea is, to the extent that it has a bond exposure, it is going to have a very short maturity, let's say in the one- to two-year range, something like that. By way of contrast, the Kinetics Multi-Disciplinary Fund uses a longer maturity.

The second part of the strategy of the Alternative Income Fund is to sell options that are even more out-of-the-money than is done in the Multi-Disciplinary Fund. To provide an illustrative example using a separate private fund we manage, when we sell a put option on XYZ Corporation, we're interested in a weighted average moneyness of something in, roughly, the 20%-odd area. So what that means is we could write a put that is 35% out of the money. We also might write a put that is 5% out of the money. Executed in certain proportions, maybe the whole thing ends up being 20%-some-odd out of the money.

It is not very volatile. If you thought about the entire put option portion of the fund as one stock, or if it were just an index like the S&P 500, we're basically avoiding the top 20% fluctuation, meaning plus or minus 20%. We're avoiding that. In the Alternative Income Fund, we're writing put options 35% out of the money, so we're going for even lower even volatility. People can select the volatility posture they want.

Even though both funds gain assets, the Kinetics Multi-Disciplinary Fund gains more assets. Maybe that has to do with its longer track record. Don't forget, the Alternative Income Fund has only a one-year-and-four-month record under the new mandate, so it is still early in the game to say what is going to happen. I think both funds have done exactly what they're supposed to do in giving people an alternative to conventional bond-like strategies.

What we believe is that bonds and equities can be together, but don't have to be together in the conventional balanced account strategy. You can do a lot more interesting things. You can design an equity strategy that is designed to give you your return in the form of cash, which is additive yield, which is what people want in the first place, as opposed to a balanced account strategy where some of it is appreciation, some of it is income.

Steven Bregman – President & Chief Financial Officer

Just to put some numbers to it, so people can relate to the generalized description, if you were to write, as you do, put options that are 30%-odd out of the money on the kind of stocks you're doing that on now, at the moment, what is the annualized yield?

Murray Stahl – Chairman & Chief Executive Officer

Well, it depends on the time to expiration. I would recommend doing it for a year and a half to a year and three-quarters, which would mean a January 2016 expiration. If you did it that far out of the money, your annualized premium is, if you're lucky, 3%-ish.

Steven Bregman – President & Chief Financial Officer

Okay. What would be the yield on the bond, such as it is? Another percent or two?

Murray Stahl – Chairman & Chief Executive Officer

In the case of the Alternative Income Fund, the maturity is not long enough to get you 2%. You might get something closer to 80-90 basis points.

Steven Bregman – President & Chief Financial Officer

We actually chart the results, day-by-day, week-by-week, and it is far less volatile than an ordinary bond portfolio.

Murray Stahl – Chairman & Chief Executive Officer

Right. The portfolio we like to use, incidentally, just for our own internal purposes to chart against, is the iShares Core Total U.S. Bond Market ETF (formerly the iShares Barclays Aggregate Bond Fund). Why do we like to use that? Because it is the whole investment-grade bond market. It represents everything that is out there, including mortgage-backed securities, long-term bonds, short-term bonds, governments, corporates, whatever it happens to be.

If you bought everything in that bond market, or you bought that index, you're looking at a 2%-ish yield. It has a weighted average maturity of nearly seven years. If interest rates were to go up rather rapidly, there is a certain kind of market risk. Even if interest rates don't go up rapidly, the return is 2%. It is not big. If you can create a fund where you can achieve a return of, let's say, 5%-6%, 6% is a stunning victory if the benchmark is two. That is the objective. I think there is a tremendous amount of capacity there.

Steven Bregman – President & Chief Financial Officer

When we meet people who have an income yield need, and they hear about the Alternative Income Fund, they kind of begin to nod their heads "Yes." They are willing to try it. And once they try it, we find they tend to like it.

Questioner 2

Would it be feasible to provide an aggregate fee structure for the hedge funds, or is that not possible? Just to roughly quantify it. I realize that it is probably dynamic.

Steven Bregman – President & Chief Financial Officer

I think it is actually technically feasible, but I'm not sure it is a good idea to provide. There are various formulas; sometimes a marketer will get a piece of something, and there's one arrangement or another. Even if I were to say that this given fund has a 20% incentive structure, or 15% above a certain hurdle rate, then to actually provide you a valid figure would be a little complicated.

Questioner 2

From a valuation standpoint, is it safe to just say that it falls within the normal range of today for other hedge funds industry-wide?

Steven Bregman – President & Chief Financial Officer

I would say it is a good assumption. We've been intrigued over time by looking at companies to invest in, such as a purchase in a portfolio or a given strategy. We come across different money managers over time, and some specialize in one kind of strategy, and some in another, and some are big and some are small. At the end of the day, somehow, their net profit margins all seem to be pretty close to each other. There are a certain number of mouths to feed, and then certain expenses you have to have.

It is a rare company that actually, on a sustainable basis, can have a much higher profit margin. At least, that is what we see. In the world of private funds there is a certain sameness over time if you have a firm that is reasonably diversified in terms of the number of funds it has or the product mix it has.

Murray Stahl – Chairman & Chief Executive Officer

Which raises another question, which I should throw in right now, which is why we created the revenue share in Horizon Kinetics. In theory, we can make a deal with a marketer, or in Horizon Kinetics we can pay ourselves bonuses. We can do all sorts of things. So, let's not forget about that revenue share, which is not far from 5% of Horizon Kinetics' revenue and which goes directly to FRMO. From the point of view of a shareholder of FRMO, at least insofar as the revenue share is concerned, it doesn't really matter what the expenses are. Whatever we do, it is designed so that the FRMO shareholder can participate directly at the top line.

We didn't want to be constrained. And now you'll maybe understand why we have this structure. We didn't want to be constrained about making an investment, either in people or in resources or machinery, if we thought it made sense. Sometimes, like happened some years ago, the market went through a huge downturn; we were hiring staff through the downturn, because we thought it made sense. We were building the operational infrastructure so we could do the kind of things with products that we do now. And the time to make those kinds of investments is during a crisis like that, when Wall Street is laying people off and talent is available.

Of necessity, our earnings would be under pressure, because we were spending money. And our revenue in that environment—we're now talking years ago—was certainly not going to go up. It actually did go down. However, from the point of view of the FRMO shareholder, to the degree that we can insulate them, it didn't really matter. Of course, in those days, we had direct product shares; now we have the overall corporate revenue share.

We don't want to be in a position where we're trying to manage the earnings quarter-by-quarter and creating an incentive not to make an investment, not to proceed with a project, for an earnings reason, just because it involves an expense. On the other hand, we don't feel it is appropriate to entirely penalize the FRMO shareholder because we decide to make an expense. So, a reasonable compromise was the revenue share. From that standpoint, to at least that degree, the FRMO shareholders are insulated from the expenses, whatever they are—marketing, payments, or bonuses, whatever it is we decide to do—which is a unique choice in the world of corporations generally.

Steven Bregman – President & Chief Financial Officer

The closest I can come to it—and it is a pale comparison; it really is not as good—to demonstrate that the 4%-odd revenue share is extremely valuable, is to compare it to a royalty. It is a royalty, basically, not subject to manipulation or added expenses. The closest I can come to it, off the top of my head, is the burger joints, the chains, like Burger King Worldwide and Wendy's and McDonald's and so forth. They have a mix, even if it is lopsided, of company-owned restaurants and franchise restaurants.

And mostly they try to get the maximum ratio they can of franchise restaurants because, in the franchise restaurants, the parent company, the corporation, only gets about a 4%—call it a franchise royalty—from the franchisees. But their operating margin on that is 80%. And on the company-owned restaurants, where they actually have to own something and manage it and pay salaries and expenses and rent and so forth, they have about a 20% margin. So, the value of anything that approaches a royalty is really very high.

Questioner 3

I just wanted to ask you two questions. The first is a very broad question, but where do you see FRMO Corp. over the next 5-10 years? The second is: At any point in time would you or the management team every consider buying an insurance company to create a more permanent base of capital?

Murray Stahl – Chairman & Chief Executive Officer

Those are two good questions. I'm going to take the latter one first, because the second one is a little more complicated, but I'll answer them both, of course.

We've considered the question of being an insurance company or buying an insurance company. As you know, we now have a status in Bermuda, we've investigated Bermuda a lot. They've got it down to the point where it is a turnkey business. We could go down there and we could very quickly create a reinsurance company or some other insurance company. We could do it.

And, after deliberation and due consideration, we rejected that idea. Not that it doesn't come up from time to time, and not that people don't approach us and offer us means and modalities to do that. Every time we talk about it among ourselves, Steve and I, we end up rejecting it. Here is why: because, even though we'd have a bigger permanent capital base, quicker than we otherwise would, the problem with it is we are exposed to the odd event.

There is Hurricane Katrina or Hurricane Sandy or whatever other such event occurs; not that we have to be in catastrophe insurance; we can be in some other kind of insurance. But we don't like the idea that, because of some three-sigma event, our shareholders' equity could decline by a meaningful amount, and thereby disrupt our growth plans for years—because we would be, at least to the extent that would happen, drained of that much capital, and it might take years to replenish that. We just don't like that.

We came up with—and now we get into where we want to be in the next 5-10 years—we came up with a better deal, at least I think it is a better deal. So, what I'm going to do is I'm going to compare and contrast the Wealth Masters Index—in success mode, because it doesn't necessarily have to be a success—but let's compare it in success mode to the insurance business. Now, in the insurance business, of course, you earn float. And it is positive income to you until such time as you have the calamity. And then you pay out, and that is a certainty—if you didn't have the calamity every now and then, no one would pay you the income. So, there is a recourse among the insured parties to your balance sheet.

Now, let's compare and contrast the Virtus Wealth Masters. We get X basis points on the AUM balance. And we don't have to pay agents to sell our insurance, and we don't have to pay a whole bunch of lawyers to figure out are we or are we not violating some insurance law. We don't have to answer to insurance regulators, and we don't have to worry about our capital that is going to be drained. We get X basis points.

Steven Bregman – President & Chief Financial Officer

I would add to that, when we were seriously investigating, more than once, the possibility of establishing some kind of insurance subsidiary, I was given a long tutorial one afternoon by someone who had actually built one from the ground up for another investment firm that had done just what we were talking about. And, indeed, they had avoided—because they were also a conservatively-oriented firm, they wanted to avoid issues of undue periodic risk. And they went into a low-risk bread-and-butter type of insurance business, with short lives, just workaday niche type of insurance and so forth. And many purveyors will even send you a team that will do this for you.

And I think he did it successfully. But, as he explained it to me, what became apparent was there was so much effort involved not merely in setting it up and managing it, but you also have people involved, and you have your underwriters, and you have lawyers—the distraction clearly was great. And this fellow, who was very bright, who set it up for his boss, the head of this investment company, who was supposed to step into it once, set it up, and leave it—it is now his full-time job. So, he no longer is involved in investments; he is involved in insurance.

So, there is this issue—it is an easy word to say; you read it sometimes about various companies—management distraction. It would be a very big management distraction, because there is a lot of inherent risk and people involved, and you would have to oversee that.

Murray Stahl – Chairman & Chief Executive Officer

Anyway, returning to the Virtus Wealth Masters, and we hope one day to be in other indices. Not even indices, but other types of products. We know exactly what we want to do.

In the Virtus Wealth Masters Fund, we get X basis points. The more money that is in there, the more money we get. But there is no recourse to us. It is not a guaranteed successful outcome for the investors. But there is no recourse to our balance sheet. Of course we'd like the investors to have a very successful result, and do everything we can to make that possible. But, at the end of the day, there is still no recourse against us. And, at the end of the day, it involves fewer people kinds of risks, and therefore, as Steve said, less management distraction.

So, take the Virtus Wealth Masters Index, multiply it by some coefficient of expansion, whatever you can imagine it might be in success mode, and that extra revenue, drops right to the bottom line. We'll pay our taxes on that, but that is the only real liability. There are some small expenses that go up, but nothing even remotely approaching what the increase in revenue is going to be. I would say the increase in expenses is so small that it'd take more time to quantify it than it is worth. It is just a really meaningless amount.

We're trying to do more in that vein. Investors are not happy with the securities they have to invest in, even though there are tens of thousands to choose from and, if you include bonds, hundreds of thousands. To the extent that you can create products that have the characteristics the investment community wants, there is your float. What do you need insurance for? It is basically the greatest business opportunity there ever has been, because it is ultimately scalable but doesn't involve, like a normal growth company, the ordinary risks and the ordinary increase in expenses.

I will give you one more comparison. Let's just say we were a biotechnology company. Steve and I, in this hypothetical example, we're the chief bio-researchers, and we came up with some pharmaceutical that became enormously successful—it would have to be by luck, by the way, if that happened, but let's say we did it. Now we have a certain amount of revenue and a certain amount of earnings, and the world is waiting for us to increase our earnings. At some point, that drug is going to be saturated. What do we have to do? In the next year or the second year, we have to develop a drug that is going to be even more successful, that is going to have even more earnings than the previous one. If we could achieve that, then we'd have to dream up another one that is going to be even more successful than that, and so on and so forth. We basically always have to top ourselves.

The results are not cumulative, and we would have to spend a lot of money and there is a lot of product risk involved. What if the FDA declines to approve one of our creations? That would be terrible for the company. We would have spent a lot of money to bring a drug to the market. It might be $1 billion to bring a drug to the market, and we would have failed.

The monies we are putting at risk are fairly de minimis. We could lose it all and have a 100% failure rate in everything, and you would have a hard time noticing it on the income statement. Basically, if the entirety of the new business/new product effort failed, I mean failed to the degree that we didn't get a penny of revenue, you'd have a hard time, as an analyst, just seeing the effect on our financial statements. There would be an effect, it would be measurable, it just wouldn't be a big deal.

Going back to the insurance example, if we failed in insurance, for whatever reason, and it could be that we didn't assess the risks properly, which happens many times in insurance companies, or the employees or the underwriters, exposed us to risk that we didn't know we were exposed to and we didn't want to be exposed to. They could misprice the risk. Believe me, if there was an adverse effect, you would see it on the financial statements. Every time we go through that analysis—and it is more involved than what I'm just telling you—but every time we go through the analysis, essentially these issues come up, and we end up rejecting the insurance company idea. Although, on the other side, it is tempting to be able to say we can get our hands quickly on $250 million, but we always manage to resist the temptation, but most people don't resist it. I'll leave you with this thought: Oscar Wilde said, "I can resist anything but temptation." But we manage to resist it.

Operator

We currently have no further questions in queue at this time.

Murray Stahl – Chairman & Chief Executive Officer

In that case, I hope we've addressed your questions, and we will reprise this in about 90 days. We thank you for your attention. You asked some really good questions, and we look forward to our next interaction in about 90 days. Good afternoon and thank you very much.

Operator

This concludes today's conference. Thank you for your participation.

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