FRMO Corp. Q1 2016 Conference Call

Tuesday, October 20, 2015

Operator

Good day, everyone, and welcome to the FRMO Quarterly Conference Call. As a reminder, today's call is being recorded. And at this time I'd like to turn the call over to Ms. Thérèse Byars. Please go ahead.

Thérèse Byars – Corporate Secretary of FRMO Corp.

Thank you. 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 Corp. website at 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 2016 first 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

Some of you who've been on these calls in the past have gotten the impression, perhaps, that I don't see an awful lot to review in the details of the balance sheet and income statement. Murray finds them more interesting than I do. It seems like a repetition, often, of what's stated.

Before Murray begins, I'll answer one of the questions that we received in advance.

Question 1

What factors underlie the 25% year-over-year decline in consultancy and advisory fee revenue?

Steven Bregman – President & Chief Financial Officer

Regarding the sizable decline in the revenue participation for the August quarter of this year versus last year, primarily, we're talking about the 4.2% revenue participation that FRMO Corp. has in Horizon Kinetics. That decline is primarily due to the absence in this quarter versus the last year's comparable quarter of crystallized incentive fees mainly for one of the hedge funds. It's a hedge fund that happens to have quarterly crystallization. So, that accounted for the largest portion of it.

A lesser portion was related to lower assets at the Kinetics Mutual Funds. As you might imagine, if one looks at the variety of assets Horizon Kinetics manages with respect to the end users, the clients of mutual funds probably have the least fidelity to what we do; they're the most distant. Assets leaving actively managed mutual funds would be entirely consistent with what has been happening across the spectrum of asset management. So, that's the essential difference.

And that's it for me.

Murray Stahl – Chairman & Chief Executive Officer

Thank you Steve. I'll make some general remarks, then I'll address the remaining questions. My remarks will cover a little bit about the financial statements, but mostly activities that we're up to that you're probably not aware of. This discussion also should answer, if indirectly, the question that was submitted regarding the competitive environment for indexation products.

To begin with, you're not seeing it now, but you'll see it in the next quarter, and I'll elaborate more on it as we go through this, but you're going to see the appearance of an investment by FRMO in a new fund. In the beginning, we'll make a small investment in this new fund. The idea is to be extremely concentrated. Now, being extremely concentrated in a portfolio is not for the faint of heart. I need to tell you that. But it's really an outgrowth of indexation.

I'll come back to the investment FRMO is going to make. It's not going to be a big investment, but it's going to be an investment. And there will be other monies in it, which is mostly ours, and we're going to have to consolidate it. The complexion—the look of the balance sheet—will be a little bit different. From your point of view, the difference, essentially, will be that we will have more total assets.

Basically, if you think about indexation, and you think about diversification as it was expressed in the book written, I guess it's now 60-plus years ago, by Harry Markowitz about portfolio selection, the idea expressed in that book is that if you buy 10 stocks, you have diversification. The view today is that you might buy 10 indexes, each having 1,000 stocks, and then you have diversification. I've written about this a lot but, for our purposes, let's summarize. The basic problem with that approach is that you bring into your portfolio all kinds of tendencies that you really don't want.

For example, we don't own Wal-Mart, but I'll use that company as an example. It disclosed that next year's earnings are likely to be down, which is a problem. I have nothing against Wal-Mart; it's just one of those things. Obviously, they're going to call in their various vendors, which number in the many, many thousands, and they're going to ask for various price discounts or other concessions to help their earnings. And they have the financial power to achieve that.

Well, if you own the index, it's just one company, in principle, that has an issue out of, theoretically, 10,000, if you own 10 indices each having 1,000 names. But Wal-Mart is going to affect hundreds, possibly thousands of companies. Therefore, when you talk about having a minimal exposure to one company—and it might be only a handful of basis points—in actuality, you may have a very great exposure to it.

In a much more pedestrian example, people will talk about the slowing of growth in China and how problematic it is for many companies in the United States, Europe, and Asia. In theory, you might not have exposure to Asia, because you might own only American indexes and European indexes. You might have made the conscious decision to avoid Asia, and you might have been very right in doing that. Nevertheless, even by having only American companies or only European companies, you have exposure to Asia, because in reality they're not just American companies or European companies; they're global companies.

In looking at the indices on a look-through basis, it's very difficult to figure out what exposure you really have. We think the world will go to concentrated positions where, whatever risks it might have, at least you know what they happen to be. We might be very wrong in this, but we believe the way the investment world is going to develop is that people will pick a certain number of managers with heavy concentrations, and they'll get their diversification by investing with a handful of managers with narrowly diversified or concentrated portfolios. They'll weight them based on where they think the risks are. That's a big change from what we've experienced the entirety of our investment careers, and mine dates back to 1978.

In a way, I, and many other people, were spoiled by the investment world of the last three and a half decades by the fact that it almost didn't matter what you bought since, almost for the entirety of my career, interest rates have been coming down. Valuations, as a generalization, were going up. You could even make mistakes in terms of earnings prognostications and other predictive factors and actually do reasonably well as an investor. As I said at the annual meeting, I believe that is over and done with.

I think the entire investment world is going to have to retool. And it's not just us; it's everyone. I believe it's a major turning point in investments. We're just about to engage in a different type of investment and I think you'll find it interesting. You'll see some intriguing investment products, and you'll see things being done in a very nontraditional way. That's what we've always done in our careers. We've branched away from traditional practices. Perhaps we're going to be early in this case, as we've been in other cases, but we're doing it.

Regarding Winland Electronics, you might ask, "What the heck do you people know about electronics?" And the truthful answer is, "Not very much." That is the reason we have organized the various investments with the greater risk to be more distant from the corpus of the company. The risk we're willing to take determines how much money we put in it.

At the time we invested the $460,000-odd in Winland, basically we were buying that 15% stake at a discount to its then book value. There was a larger margin of safety. Now, it's actually trading at a better valuation, and there are some interesting developments in Winland.

One development I can talk about generally is that Winland has always been a seller of electronic components, but it has added a service called Insight. What does this service do? The idea is that Winland sells the monitoring devices, and then it is responsible for actually reading the data. For example, an application might be for a hospital that must refrigerate pharmaceuticals at a certain temperature. What happens if the power goes out or the refrigerator stops functioning for some other reason? A lot of very expensive pharmaceuticals could be lost. The idea is for Winland to monitor that temperature on a 24/7 basis. It earns a fee for monitoring and contacting the client in the event that something is amiss. That service is a departure for Winland: it is recurring fee revenue beyond selling the devices. In the history of Winland, it has never done that and it is just starting this service. The initial indications are pretty good, but take it with a grain of salt, which you must, because it's just beginning.

If you research the subject of recurring fee businesses, where the investment is up front and the marginal revenue is very close to being marginal profit, you will see they are not infrequently sold. A recent sale of such a business—I won't quote what it was, because I don't want to compare Winland to this company—was sold at 50x revenue, just to give you an idea of the possibilities.

Also relating to Winland, we talked in the last shareholder meeting about the investment in Exhibits Development Group ("EDG"). FRMO invested in a specific exhibit created by EDG. It's actually more remote from FRMO, because FRMO is not a direct participant; rather, it is a participant through a subsidiary of Winland. We're exposed to the tune of something like $15,000. So, if all goes amiss, if you look through to FRMO, we could theoretically lose $15,000. So, I don't think it's a big risk. Perhaps we should have invested more.

Anyway, the exhibit FRMO invested in is called the Beatles Magical History Tour. The first exhibit was in a science museum in Vancouver, Canada. I don't have the final figures yet but, assuming I've been reliably informed, and I think I have been reliably informed, it's the second-greatest success in the history of EDG. The only bigger one, I'm led to believe, was the Sherlock Holmes exhibit. So, at least the first indications are reasonably good, and we are hopeful that the business will grow and prosper. But, if not, on a look-through basis, we would be out $15,000.

I tell you that not because of the promise of the businesses. I tell you that to give you an idea of how we're structuring these various investments. As you can see, in a corporate sense, just by glancing at the balance sheet, FRMO has more cash than it's ever had before in the history of the company. We're probably more conservatively postured than we've been in the history of this company, other than maybe the inception when we had nothing but cash on the balance sheet.

I'll come back to the reason for that in the end. I talked about it in the shareholder letter, and I talked about it at the annual meeting. But what I'd like to do, if I may, is handle the remaining questions, and some of this topic will come out in the questions and the answers thereto. Then I'll give a summary, and we'll talk about the balance sheet posture which, of course, affects the return on equity, both in the short run and the long run. So, let's get to the questions.

Question 2

Would you please provide an update regarding your previous plans to up-list FRMO from OTC?

Murray Stahl – Chairman & Chief Executive Officer

We didn't do anything in this quarter to advance that process. A little of it has to do with the balance sheet posture. At the moment, we're not aggressively making investments. So, I don't know how excited people are going to be to invest in a company that has, as you can see, nearly half of its total assets in cash and receivables. So, we didn't think it was important to do at the moment.

Were we in a more aggressive investment mode, which we might be in the not too distant future, we'll certainly revisit that option. But I don't think it's going to help us in the short run. We're not forgetting about it, we just didn't think it was worth the investment and the effort at the moment.

Question 3

Regarding FRMO's investment in OneChicago, the major theme of the exchange seems to be to allow participants to finance equity positions at more favorable financing rates than the usual higher margin rates. What do you see as the growth drivers for OneChicago? Are there possibilities to increase our small ownership position?

Murray Stahl – Chairman & Chief Executive Officer

Let me handle the second part of that question first: yes, there are possibilities to increase our small ownership position, and perhaps one day that's going to happen.

As to the growth drivers, believe it or not, one of the ways the big investment banks—that are really the prime brokers—are shrinking their balance sheets is by forcing the exit of various hedge fund or financial-related clients. It's the easiest way to shrink their balance sheets.

Why do they need to shrink the balance sheets? For the simple reason that the regulators, in their infinite wisdom (and maybe the regulators are right), believe that the largest financial institutions, which happen to be the biggest prime brokers, are too systemically important to the U.S. economy to be allowed to operate at the scale they operate today. So, they'd like them to be less systemically important, if possible. An easy way for such an institution to downsize its balance sheet is to withdraw credits, or withdraw financing, including the possibility of financing, to hedge funds and like vehicles. I think that will ultimately have a favorable result for an exchange like OneChicago.

That's what's going on. I think it's only in the initial stages. You know the systemically important financial institutions as well as I do. All you need to do is go to the SEC website, print out their 10Qs, look at the balance sheets, put them on a table, lay them end-to-end, and you'll see what's happening to total assets. And it'll give you an idea of what's going on.

Believe it or not, some of these banks have even gone to the extreme that if there is a money management firm involved in hedge funds, however tangentially, they actually will not only withdraw financing from the fund, they'll actually ask the company in question to remove its checking account from that institution.

Steven Bregman – President & Chief Financial Officer

It's not theoretical to you as shareholders, because FRMO Corp. was sent a polite but firm letter earlier this year from JPMorgan Chase, asking us to please find other arrangements for the not insubstantial amount of cash we kept in a checking account there, because somewhere in their system, they identified FRMO Corp. as being associated with a hedge fund. And we did so.

Murray Stahl – Chairman & Chief Executive Officer

Even though we make investments in hedge funds, we don't actually operate any hedge funds. But such is life. We had no trouble finding another home for our checking account, so it was not an issue.

Question 4

This question is about the types of business attributes that you (meaning FRMO) think would be most important in a possible purchase. You have been targeting owner operator companies in the portfolios, but I wonder if the operational structure is more important than the CEO? One of the first investment books I read was *The Money Masters* by John Train. Warren Buffet is quoted in that book as stating that the ideal business is a "royalty on the growth of others." Since this is basically what FRMO is, it caught my eye. Is that type of business what you are looking to buy? Are there companies that you admire that could be cited as examples?

Murray Stahl – Chairman & Chief Executive Officer

In our investment work, we happen to like owner/operators, but it's not really a requirement. We like dormant assets, which we define as those that are potentially productive, but that are dormant at the moment. Generally speaking, we have this idea we call the equity yield curve, which is the idea that an asset might be productive in a year or two. It's a discount rate that the market applies to an asset that's potentially productive rather than actually productive at the moment. That discount is very steep and, not infrequently, you can get real bargains by focusing on that. So, we pay a lot of attention to dormant assets.

We also pay a lot of attention to what we call optionality, and dormancy is just one example of that. It's possible to get a lot more revenue without a lot more expenditure. So, we spend a lot of time thinking of that. OneChicago is an example of optionality, as are exchanges. If you find a small exchange that, in principle, can take a lot more business on its platform, you don't need to increase the expenses very much. That's an example of optionality. That's why you'll see that we have some exchange investments on the balance sheet like the Minneapolis Grain Exchange, OneChicago, and the Bermuda Stock Exchange. And we wouldn't mind, if we could do it, to find a few more.

The question references *The Money Masters* by John Train, and the Warren Buffett quote about the ideal business being one that has a royalty on the growth of others. It is kind of like that, except we prefer not to say royalty; we prefer to say optionality. Why do we say optionality instead of royalty? Because it is business that is contingently there, as opposed to business which is actually there, and you own a piece of the business; therefore, you get a royalty on the growth of others. It's contingently there. At the end of the day, it's still growth. So, I guess maybe we're splitting hairs and it's talking about the same thing.

I talked about the other exchanges in the shareholder letter, so I don't want to repeat myself. For example, if you look at the Minneapolis Grain Exchange website, you'll find a few references to carbon credits. The idea is that there are all sorts of asset classes that, in theory, could trade on exchanges, but there are only a handful of exchange licenses that exist. We believe those are dormant assets in that sense, and they're inherently very valuable.

Question 5

Given your views on ETFs (shared in various Horizon Kinetics quarterly commentaries), what is your thesis for owning exchanges (MGEX, Bermuda Stock Exchange, OneChicago)? I suspect a collapse of the ETF "bubble" will negatively impact exchange trading volumes and fees. Why not invest in exchanges where there is growth in the underlying economy and retail share ownership is low?

Also, where are you uncovering cheap optionality?

Murray Stahl – Chairman & Chief Executive Officer

I don't know that I'd call the ETF phenomenon a bubble. More about that in a minute. But let's just deal with Bermuda as an example of the phenomenon. If you go on the Bermuda Stock Exchange website, and you look at the stock trading volume, as much as I like Bermuda, in all deference, and with the greatest respect to Bermuda, there's not a lot of stock trading volume there. There really isn't.

That said, I can't say that we're worried that it's going to disappear. There's not very much equity trade volume on the Bermuda Stock Exchange, and there's not a lot of ETF trading. Whatever will happen to ETFs, I don't think it's going to have an impact on the Bermuda Stock Exchange, at least not one that I think will be material.

What the Bermuda Stock Exchange does have are insurance-linked securities, which is a different asset class and it's growing. Fortunately or unfortunately, it has nothing to do with ETFs. As a matter of fact, if there were a huge problem in ETFs, I think, if anything, it would help the growth of insurance-linked securities, not hinder it in any way.

Returning to the question of an "ETF bubble," as I said, I would be reluctant to use the word "bubble," because that term refers to conditions where there is, in the words of Alan Greenspan, "irrational exuberance," characterized by people applying preposterous valuations to securities, and where there's a general misallocation of capital. There might be some of that misallocation of capital right now. To give you an example, you could talk about very expensive securities on the exchanges, like Amazon and Facebook, and compare them to Morgan Stanley, which trades at tangible book value, give or take a percent. So, you can't very well call Morgan Stanley expensive right now.

The real problems with ETFs are not overvaluation or undervaluation. The real problem is that allocations are being made to various securities based on their marketability, meaning how well an agglomeration or set of securities appeals to investors as a marketing concept, as opposed to as an investment. Try this on for size: go to the various ETF websites, and look at the fact sheets where the portfolio beta is provided.

Now, for those who don't know what beta is, beta is a measure of volatility. The S&P 500, by definition, has a beta of 1. If a portfolio has a beta of greater than one, it's more volatile than the S&P 500. If the beta is less than one, it's less volatile than the S&P 500. I have written about this at length in my research. For our purposes, if you look at a broad list of ETFs, you will see that it's very hard to find one with a beta greater than 1.

In this connection, I don't want to mention names of ETFs, but if you get a list on your screen and choose some that you think are exotic, such as for emerging market nations or even pre-emerging market nations, also known as frontier countries, they might include companies located in countries like Pakistan. With due reverence to and respect for the nation of Pakistan, if you live there, I personally think it's a thrill a minute. You might have a lot of bad things happen to you, but you will not be bored. If you look at ETFs that have exposure to countries like that, you will see that they don't have a beta of 1; they have a beta much less than 1.

Go through the various categories, and you will see there's hardly any ETF with a beta greater than 1. Why don't you see betas greater than 1? Well, a beta greater than 1 is not marketable, and you can determine the marketability by looking at the assets under management of a given ETF. The whole idea is to raise money—lots of it—in a highly scalable fashion, and to not have a lot of incremental expenses. As a business, it's great, and I don't blame people for trying to do it. It's just that it's not a way to make investments.

If you make a list of the betas of a variety of ETFs, you'll see that the result is preposterous. It will include what we know to be baskets of highly volatile businesses (such as biotech) or countries (like Peru), yet which all display betas less, often markedly less, than the S&P 500. But today, investors and advisors have computer-driven asset allocation models, and they're not going to allocate funds to a portfolio with high-beta stocks in it because, obviously, that would raise the beta of the entire portfolio. The whole idea of broad-based diversification via indexes is to attain lower volatility.

The world wants low volatility, and they're going to figure out a way to get it, because that's how you raise a lot of money. Securities are selected not because of their investment characteristics, but because of their marketability, and their beta characteristics, meaning their volatility characteristics, which have become a critical check-off feature of marketability. That is a very, very different situation.

There are a lot of ways of calculating these volatility statistics. You will see in each and every one of these sites, if you read the fine print, various warranties and disclaimers telling you that these statistics are deemed to be accurate, but they make no warranty they really are. You will see things that I think are really incredible. It's distorting the asset flows into, and clearing prices of, everything and anything. And it's really dangerous.

This environment is one of the reasons why we have a lot of cash on the balance sheet and why we have a lot of cash in the accounts. We're not aggressively making very many investments. I don't think it's a situation that can endure for very long. Maybe I'm wrong—I hope I am wrong.

The second matter that I alluded to was that we've all been spoiled by the fact that we have had ever lower interest rates for over three decades, and that has led to higher valuations across all sorts of sectors and assets. Basically, it was possible to have a portfolio of companies, not all of which were outstanding, and actually do reasonably well because of higher valuations. I don't think it's possible to have that anymore.

Therefore, I believe one has to be a lot more narrowly focused. I don't think one will get a good result out of ETFs or indexes, even if rates don't go up. If rates do go up, it's pretty obvious that the movie of the last 33 years is going to start running in reverse. Because institutions in general, and individuals in particular, really do need diversification, they will have to get it through other asset classes. To the extent that there are exchanges focusing on nontraditional asset classes, which are still in their infancy, I think the investments make a lot of sense.

I don't believe there will be a collapse of ETFs. I don't think the story of the last two decades in indexation will run in reverse very rapidly. I think indexation, at least for the foreseeable future, is here to stay. And that has pretty negative implications for returns in general. It has negative implications for pension funds, foundations, and all sorts of other institutions. I've written about this topic in great detail, so I won't bore you anymore with it. But it's a big problem and, as we do in everything else, we're moving in a completely different direction.

So, that's a long-winded answer to your question about our views on ETFs and why we're investing in certain exchanges. You might observe that we're not buying the major exchanges, because the major exchanges are the hosts to the major asset classes. So, I hope that answers your question.

Question 6

How does Horizon Kinetics market its products to wealth management professionals and retail investors?

Murray Stahl – Chairman & Chief Executive Officer

We market our products in two ways. One is that we have our own dedicated marketing team. The other is that we have teamed up with a couple of third-party marketers that market our products on a best-efforts basis, meaning we pay them a fee if they manage to raise money. So, that's how we do it.

Question 7

I am particularly interested in better understanding the securities sold short portfolio. Could you discuss the mechanics of this strategy a bit more? In your annual letter, you mention that now much of the exposure is hedged. Could you discuss this point a bit more specifically, unless competitive considerations would warrant otherwise? How can we think of the potential for returns going forward? I know you have likened it to providing the leverage that might be possible with insurance float, although without the risk of having to pay any of it out. But, what is the potential size of the short-term mark-to-market risk, and how much capital must be on hand for these eventualities, and how has the recent increase in market volatility affected these trades? Also, how long can one count on the deferred tax liabilities they generate remaining deferred? More generally, I'm just trying to get a better idea of how to think about these strategies and hope you can provide an intellectual framework so shareholders can make up their own estimates of their value to the company.

Murray Stahl – Chairman & Chief Executive Officer

We have a lot of questions there. Let me first discuss it in general terms, then I'll discuss it a little more specifically. I won't disclose the specific names that we short for reasons that I hope you'll understand are self-evident.

Regarding the mechanics of the strategy, there exist securities that the academic literature would define as path-dependent. What does path-dependent mean? Path-dependent means that, if you are short them, even though they go against you for periods of time—sometimes for elongated periods of times—in the long run, they will go down. It's really that simple. So, those are the funds that you want to be short.

When I say the exposure is hedged, it's not hedged in the sense that we found a need to deliberately short a security that would offset another security that's short. We did not do it to hedge our exposure against the short going the wrong way and being horrible for the balance sheet. Rather, we did it because the ETF sponsors continue to issue more of these funds and, more by happenstance than anything else, it turns out that two positions in the portfolio actually work differently from each other. It's not that we consciously said, "I have $100 in Security A and it's short; let me set up a security position of $100 in B so that the two are going to offset." It really wasn't that. It was that Security B looks kind of interesting on its own, and an inadvertent but very desirable consequence is that it's likely to work when the other security is not working. In that sense, you could say that it might be hedged in a certain way, but it's not done intentionally. Therefore, the idea is not to control the volatility of that segment of the portfolio, but that it's going to be what it's going to be, like it always was.

Let me give you an example. Again, I stress that we are not short this ETF. I make no warranties or disclaimers about whether this is good or bad. It's just to give a theoretical example of a possible strategy to take advantage of dysfunctional ETFs. But we're not doing it. The example is as follows: There is a leveraged inverse ETF called the Direxion Daily Junior Gold Miners Index Bear 3x Shares (JDST). That means they are short the Junior Gold Miners index with 3x leverage. I stress again that we don't own it and we're not short it. I have nothing against it; I have nothing for it. I'm merely giving you an example of how path dependency works, and I happen to be using this ETF as an example.

The short position in this theoretical example is based on the Market Vectors Junior Gold Miners Index. In the last 3 to 4 years, gold stocks have gone down considerably, but the junior gold miners have fared even worse. How much are they down? I don't remember if it's down 75% or 80%. Whatever it is, it's not important for this illustration. I'm merely giving you a sense of what's happened. It hasn't been pretty.

Let's just make believe that it was down 80% in the last 3 to 4 years. Theoretically, but not actually, had you been short the Junior Gold Miners Index, and had you been able to be short on a leveraged 3x basis, in theory, you would have made 3 times 80%, or 240%. That would be a really outstanding rate of return.

Unfortunately, had you purchased this ETF (the Direxion Daily Junior Gold Miners Index Bear 3x Shares (JDST), without being too critical of it, you didn't make 240%. As a matter of fact, you didn't make 120%. As a matter of fact, you didn't make 80%. As a matter of fact, you actually lost money. And the amount of money you lost—I don't have the screen in front of me, and I'm not calculating it, but let's just say, as a true generalization, the amount of money you would have lost is not inconsiderable, as a proportion of what you would have invested.

How and why is this possible? Let's just use the example of leverage. Since we're doing this over the phone, without a blackboard, I'll make believe it has 2x leverage, just for the fun of doing it. Let's say there's an investment that you want to make on 2x leverage. You invest $100 in this security and then borrow another $100, so that you have $200 in it. Let's just say it went up 100%, for the sake of argument.

Okay, you invest $100 of your own money, you borrow $100, you have $200 of capital working for you, even though only $100 is your own. And, if the security doubles in price, your investment is going to become $400. Very simple.

Now let's make it ever so slightly more complicated. We'll make a distinction between if I engaged in this transaction myself and if an index did it. If I do it myself, I have my $100, and I borrow $100. Luck is with me; it doubles. What do I have? I have $400 in equities and I only owe $100. Theoretically, I have $300 that belongs to me. In other words, if I cash out that day, I could sell $400 of securities, take $100 to pay back my loan, and $300 belongs to me.

Now, let's just say that, for whatever reason, I don't want to sell it. I leave it alone, and luck is not with me. In due course, that security or that index declines by 50%. What happens to me? I'm back to even. The $400 becomes $200. I have my $100 of equity. I still have a loan of $100. And what did I accomplish? Not much of anything.

An index doesn't work that way, because an index, by charter and by law, must be formulaically constructed with precision. It has to have the same exposure every day. If you operate that index and, for whatever reason, you do not have the same exposure every day, if you have different exposure every day, you could be in a lot of legal trouble. You might even go to jail if you tried something like that. So, this is what you need to do if you are the index.

It starts out just the way it started out in my previous theoretical example of a personal portfolio. Someone contributes $100 to the ETF. The ETF borrows $100 to attain 2x leverage to the underlying index. Let's say the index doubles in price. We're making believe this happens in a day. Obviously, it doesn't but, for purposes of illustration, let's just say it did. At that moment, the same thing happens as happened in my theoretical personal portfolio. The $200 becomes $400. There's $300 of equity there and $100 of loan—except that the ETF needs to be 2x leveraged. At that moment, when it has $300 of equity and $100 of borrowings or loan, it's not 2x leveraged. It needs to get 2x leveraged, which is to say it has to have $600 of exposure on its

$300 of equity. How does it get 2x leveraged? The only way to do it is to borrow $200. So, it borrows $200 and buys another $200 of the security.

Now, just like in the theoretical example I gave in my personal account, let’s say the index goes down by 50%. Well, the $600 becomes $300. But in this example, it started with $100 of borrowings and it borrowed another $200 at the top. This is an important point that I’ll return to in a moment: $300 of value is wiped out ($300 is half of $600), and the ETF is left with $300 of loans. The investor has nothing; they’re at zero. That’s path-dependency, simplistically expressed.

I used examples that were deliberately exaggerated to illustrate the point. It’s unlikely that these indexes will move 100% in a day. However, having said that, if you look at the triple-leveraged ETFs, I won’t say they move 100% in a day, but there are days when they move a lot, let’s put it that way.

In essence, what’s happening is, because of the legal structure, if you buy something long, as in the example we used (or sell something short), whenever the strategy works in your favor, whenever the optimal point comes, when it’s not going to go up anymore, you’re going to have the maximum exposure. Whenever the minimal point comes, which is when it’s going against you, it works in reverse. You’re going to have the minimal exposure.

So, you’re going to be too much either long or short when the security is at its high, and too little long or short when the security is at its low. And you’ve got to be in the reverse stance. But the structure won’t let you. Over time, these securities diminish in value. We feel it’s a lot better, if you’re going to get exposure to something, to get exposure that way, and to benefit from the short position.

I also should tell you that, when this class of ETFs are 3x leveraged or 2x leveraged, they’re really borrowing money, and there’s a cost for that. If you’re 3x leveraged, whatever the interest rate that’s implied in the swap—these exposures are usually done in a swap—it’s built into the swap. Whatever that interest rate is, multiply it by 3. There’s also a management fee; usually it’s 95 basis points. Oddly enough, if we sold $100 of something short, believe it or not, we would be earning 95 basis points.

Let’s say all the other things didn’t happen. If we want to have another $100 of assets under management, the easiest way to do it is to sell $100 short in one of these leveraged ETFs, and now we’re getting a 95-basis-point fee, which is actually a pretty good fee relative to what we normally get. There is an operational expense, but we don’t have to pay a marketing fee to get it, so it’s a pretty good deal. It’s actually better than running money. That’s a small consideration in what we do.

I’ve gone into this detail to show you how this strategy works.

Another part of the question compares the tax deferred status of income generated by this strategy to insurance float, but it's much better than insurance float, for a couple of reasons. First, there's no insurance commission that regulates you. You don't have to worry about that. You don't need a staff of people to interface with the insurance commission. You don't need lawyers. You don't have to make up convention statements. You don't really have to do anything like that.

You sometimes have mark-to-market losses against you, but it's just a mark-to-market accounting entry. You're not paying it out. As I said, there will be times when it's mark to market against you, but that's not the end of the world, because now you see from the theoretical example that when it's mark-to-market against you, it's a great time to be short, because the ETFs are usually at their maximum exposure. It's also, effectively, being short an index, which is very unlike being short a stock, because there are limitations on how far it's going to go. The index will not be bought out, there won't be a hostile takeover, or other risks like that. It's interesting, as far as that goes.

Regarding how long the deferred tax liabilities this strategy generates can remain deferred, there are two points to make. The first is that we're getting better at implementing this strategy, because we have more experience with it. Second, we're finding among the ETFs we've been shorting recently some that allow us to keep it deferred for much longer.

That said, we sold some ETF options short some time ago. Sometimes we don't even accomplish it with an ETF; sometimes we actually take an option on an ETF, because it's decaying. It's not a huge amount of money but, in January, those options are going to expire, and it looks like they're going to expire worthless, which is a good thing. When they expire worthless, we're going to owe a tax on it, but it's not going to be a big deal. There are some on which we might be paying taxes in the not too distant future. In other cases, it's going to be deferred for a long time. We're trying to defer it as long as we possibly can, because it's float. In any event, because we're not taxed at 100%, whether we pay taxes or not, we are keeping the profit. This strategy is kind of interesting as far as that goes.

That's quite a prolonged exposition on the subject, but I hope I've given you enough detail. As I said earlier, Direxion Daily Junior Gold Miners Index Bear 3x Shares (JDST) is merely used as an example; I'm not personally using it in a strategy. Do what you will with it, but you're on your own. I just gave you the example. You can get all the statistics. You can get the prospectus. You can read up on it. With a little research, you will see that it is not the only path-dependent ETF. There are quite a few.

Question 8

After leaving the annual meeting, I realized that no one had asked you to discuss a stock or two that you like. Although, given your current lack of enthusiasm for equities, perhaps there are none.

Murray Stahl – Chairman & Chief Executive Officer

Normally, we do, and there will be a time when we do it again. At the moment, however, with all due respect, we're going to punt that question a little bit because, as you noted, we're not that enthusiastic about the equity market, and we're not buying too many things.

That said, however, you will recall earlier that we talked about a concentrated or undiversified fund, if you prefer, that we're investing in. There's obviously at least one stock that we're buying. If we weren't buying it, I would be delighted to discuss it with you. But we are buying it, so it's probably not a great idea.

Also, thank you for including the paper called "Why Indexing Works." I've been reading it with great interest. I'm always interested in studies of indexation. There's such a plethora of papers that I don't find everything on my own, so I greatly welcome when people send me papers. It's not unlikely that they might send me a paper I haven't seen yet. I think indexation and its impact on the investment climate is the most important investment consideration, bar none. And I think it's going to remain so for quite some time.

I tried to answer all the questions, and I hope you found it interesting. We've talked about the various activities in which we're engaged, and that exhausts everything we planned to say. Thank you all for your kind attention and your interest in our company. We will reprise this in about 90 days. We look forward to your questions; don't be shy about submitting them. Thanks so much and good afternoon.

Operator

That concludes today's call. Thank you for your participation.

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