FRMO Corp. Q1 2020 Conference Call
Thursday, October 17, 2019

Operator

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

Thérèse Byars – Corporate Secretary

Thank you, Nick.

Good afternoon, everyone. This 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 www.frmocorp.com.

Today's discussion will be led by Murray Stahl, Chairman and Chief Executive Officer, and Steven Bregman, President and Chief Financial Officer. They will review key points related to the 2020 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 Mr. Bregman.

Steven Bregman – President & Chief Financial Officer

Thank you, Thérèse. I only have a couple of minor—I'll call them pointillistic—observations to make because they're not really about strategic positioning or anything that profound. But for what it's worth, I recall that not so long ago on these calls, Murray had pointed out when we had crossed a certain threshold, a milestone, that we had $100 million of shareholders' equity in FRMO Corp. And we recently crossed another one, which is that on the balance sheet as of August 31st, we had cash and securities, net of current liabilities, of, roughly, $107 million. As of August of last year, it was $98.8 million. So, that's a new threshold.

As another observation, I'll mention something that is a strategic item, and I'm sure Murray will talk about it, which is that on the income statement, the revenues from the 4.95% interest in Horizon Kinetics declined by some $70,000-odd. And, as you know, that's a major investment for us. It's a large investment with a large revenue base.

That decline was offset almost entirely by an increase in cryptocurrency mining revenue. Cryptocurrency mining revenue is not the same as cryptocurrency earnings but, nevertheless, there was about over $70,000 of revenue from that source in the three months ended in August, and that's on a book value of all of $77,000. So, as small as that business activity presently is, it actually, more or less, offset a decline, a temporary decline, we hope, in revenue from a much larger element of the company's investments. So, there you have it. Those are my observations.

Murray Stahl – Chairman & Chief Executive Officer

In light of your observations, I just want to note that the revenue decline reflects the absence of the cryptocurrency fund performance fee for the prior year. What I'll do today is to walk you through the income statement and then the balance sheet, to help you read them, because it's not self-evident how to read them. You can correct me, Steve, if I leave a point or two out, which I might do by accident, of course. Normally, I'd make strategic observations in the prepared remarks; however, I'll leave that for when we answer the questions, which are really good and largely evoke topics we would have covered in the prepared remarks. I really like the questions, and we'll answer them at length.

I'll provide the usual information about cryptocurrency exposure, which you don't see on the financial statements. Then, to set up our answers to the questions, I'll provide some factual information that you can actually follow online—not about FRMO, but about the environment in which investment management operates, and especially those of the equity variety. Then we'll answer the questions.

You will observe on the income statement that the unrealized losses from equity securities was $4.8 million. Almost all of that comes from Horizon Kinetics Hard Assets ("HKHA"), and so you know what's going on there, almost all of HKHA consists of Texas Pacific Land Trust (TPL).

The operating expenses are pretty self-evident. Then you'll see the income from operations before the provision for income taxes, then a provision for income taxes. It's our practice to consolidate HKHA and, when you mark it down, you also take away a certain deferred tax liability. But, since we don't own the bulk of HKHA through FRMO, we have to take a flow-through to the income statement regarding the tax savings that we will not receive because we're not entitled to all of the benefit of that reduction in deferred tax liability. As a result, there is this provision for income taxes amount of $1,233,009 and that gives you a net loss of $5,570,609, and from that you subtract $5,351,747, which is the part of HKHA that we're not responsible for, and that leaves you with a net loss attributable to FRMO of $218,862.

One of the questions pertains to this next matter, but just to kick it off: On August 30th, we agreed to sell our interest in the Bermuda Stock Exchange to Miami International Holdings, otherwise known as MIH in exchange for MIH shares. As you'll see in the notes, the sale was subsequently approved by the Bermuda Monetary Authority. There will be a fairly substantial gain on that transaction, but that's not marked to market on the balance sheet. Even though the agreement between FRMO and MIH was made on August 30th, it was approved on September 23rd by the Bermuda Monetary Authority, so it was technically not a valid transaction as of the FRMO balance sheet date. The transaction will be reflected in the following quarter. Just for the fun of saying it, had it been reflected on August 31st, obviously, the numbers would have been radically different.

Here's another interesting item. When you turn to the balance sheet, on the top line you'll see $54.4 million of cash and equivalents. That's our record cash level but, much more importantly, you'll observe that even as the loss attributable to the company, calculated as I described, was $218,862 for the quarter, our shareholders' equity attributable to the company increased by about $1 million dollars relative to the prior calendar quarter (May 31st vis-à-vis August 31st). How is that possible, you may well ask.

It is possible because the mark-to-market gains we have on our short positions don't flow through the income statement; they only flow through the balance sheet. You'll observe, on the securities sold short line on the balance sheet that we're now up to proceeds of $13.9 million versus the prior quarter of $11.58 million, so we have more proceeds. Of course, when you sell a security short, there's an associated liability, but if you look at the liability, it actually declined, so all in all we made a fairly substantial profit on the short positions in the quarter. Taken holistically, it's a plus quarter for FRMO, not a minus quarter.

But these are the vagaries of the way accounting is done today, and we have to live with it. As we say from time to time, and we'll reiterate it today, we might have to change the way we configure this company just to make it easier for people to understand what we're doing, because I realize that from the outside it's not always self-evident what is actually happening. That said, I'll also give you some information on our cryptocurrency activities and some facts about the investment management operations; then we'll get to the questions.

So far, the coins FRMO has mined are 29.11 units of bitcoin, 32.06 units of Ethereum, 584.36 units of Ethereum Classic, 38.33 units of Zcash, and 188 units of Litecoin. Together they have a value of roughly $340,000, as of October 3, 2019.

If you take all of the cryptocurrency exposure from our investment interests in the funds or the cryptocurrency that we hold directly, the aggregate market value equals $6,278,100 on the day the accountants prepared this statement. That total doesn't include FRMO's interest in Digital Currency Group, which we value at cost, and you can see that in the notes of the financial statements.

Before addressing the questions, let me give you some factual information that you might not be aware of. There exist two ETFs that are low volatility versions of the S&P 500, one of which is the iShares Edge MSCI Minimum Volatility USA ETF (USMV); the other is the Invesco S&P 500 Low Volatility ETF (SPLV). Essentially, the Invesco ETF (SPLV) holds low volatility stocks drawn from the S&P 500, and the other, the iShares ETF (USMV), holds a few positions that are not from the S&P 500, but I think it's totally fair to say that they are largely elements of the S&P 500.

What's interesting is, year to date, for the three, and five years, etc., ended September 30th, both of these ETFs outperformed—handily in my view—the S&P 500, and they did it with far lower volatility. To give you a sense—and, by the way, you can follow along with me on their websites and look at these numbers right now, and you'll get the exact number of decimal places, but I'll just round to whole numbers. The S&P 500 itself has a standard deviation of 12%, while USMV and SPLV have standard deviations of about 9%. When they talk about volatility, by the way, they really mean standard deviation.

Consider this: You have indexes that are subsets of the S&P 500 that handily, comfortably, outperform the S&P 500, yet with lower volatility. From a modern portfolio theory standpoint, that's not supposed to be possible. In language of modern portfolio theory, risk and reward are related. Assuming that it is possible, you might want to question the precepts of modern portfolio theory, but even if you don't, why would you buy the S&P 500, with its inferior performance and higher volatility, instead of the low volatility variants? Why would anyone do that? In fact, though, that's actually what happens now.

If you look at recent months, the amount of money going into the two low volatility ETFs is greater than the amount going into not just the SPDR S&P 500 ETF Trust (SPY), but all of the S&P 500 ETFs. There are three S&P ETFs, which are all the same because they hold the S&P 500 index constituents. There's the iShares Core S&P 500 ETF (IVV), the SPDR S&P 500 ETF Trust (SPY), and the Vanguard S&P 500 ETF (VOO). More money is flowing into the low volatility variants of the S&P 500 than is going into the S&P 500, and for entirely understandable reasons.

Here are two observations about that. The first is from an active asset manager's point of view: Even if you outperform the S&P 500, and even if you do it with lower volatility than the S&P 500, you're very likely to underperform the low volatility elements of the S&P 500, because your volatility won't be as low, even if you have a higher return, which you're not likely to have. That puts the active asset manager in a very uncomfortable circumstance, which explains why, as per an Institutional Investor article dated May of this year, more than 50% of all managed assets are now indexed.[1] And I'm positive that number is increasing, virtually on a daily basis.

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[1] Segal, Julie. 2019. "*History Made: U.S. Passive AUM Matches Active For First Time.*" *Institutional Investor, May 17.* https://www.institutionalinvestor.com/article/b1fg0jnvbpc536/History-Made-U-S-Passive-AUM-Matches-Active-For-First-Time.

But more important than that, because people are rational in certain ways, there's actually more money flowing into the low-volatility S&P 500 variants than is going to the S&P 500 itself. Since we're doing this over the telephone, we don't have a graph or slides, but I'll try to illustrate this phenomenon. These aren't the real numbers, but let's make believe that $100 went into the S&P 500. That's an easy number to remember. Let's also make believe that $100 went into the low volatility ETFs. That puts them in equilibrium, but they're not. The actual number would be considerably higher, but I'm making them equal for reasons you'll understand in a moment.

So, $100 goes into the three S&P ETFs, which are all identical, and another $100 goes into the two low volatility ETFs. However, 100% of what goes into the low volatility ETFs is used to purchase low volatility stocks according to their rule set. But the S&P 500 is not comprised of solely low volatility stocks. Let's say—and here I'll make up a number just to illustrate—half of the S&P 500 Index is comprised of high volatility stocks and half is low volatility stocks. So, of the $100 going into the S&P 500, half will go into low volatility stocks. As a result, $100 goes into the low volatility stocks that make up the low volatility ETFs, while only $50 goes into the low volatility stocks in the S&P 500 ETFs themselves, and $50 goes into the S&P 500's non-low volatility stocks.

Even if I assign an equal amount of money going into each, they are not equal; it's $150 versus $50. The ratio is three to one. I call this outcome a reward circuit, because it's a self-fulfilling prophecy. You have all of this money going into low volatility stocks and, in my view—and I might be wrong—that buying power clearly has an effect on the valuation of the companies, and the more impact it has on the valuations of those companies, the more people will shift their allocations to buying the low volatility variants of the S&P 500, and the worse it gets from that perspective. That, in my view, is unsustainable and something's going to happen. It could be three days from now, it could be three years from now, or even longer. We have no way of knowing. But that's the circumstance in which we find ourselves. It's good for you to have that background.

With that, I'll answer the questions we received, and I think the strategic themes of FRMO will become very clear as we answer them. I'll read the questions as they're written.

Questioner 1

I observed in the quarterly filings that the shares of the Bermuda Stock Exchange will be exchanged for shares of Miami International Holdings. This was FRMO's largest investment in a securities exchange and a notable portion of our noncash investments. Please provide additional color on this transaction. I recall our principals discussing the strategic value of the exchange investments on past conference calls. Was the strategic value that was anticipated at the time of the investment realized? If not, why not?

Murray Stahl – Chairman & Chief Executive Officer

To begin with, this was a share exchange. To realize the strategic value of the Bermuda Stock Exchange required some capital and a lot of technology, which is something that Miami International Holdings would bring to bear. We're not really giving up the Bermuda Exchange; we intend to continue holding it within our Miami International Holdings stock. I think within that framework, it will have a lot more value than it had before, which will help all of us.

There's a related and not unimportant dimension as well, and it relates to another of our exchange investments. There is a significant development for the Minneapolis Grain Exchange ("MGEX"): on the MGEX website, you will see that MGEX and the Miami International Securities Exchange ("MIAX"), are partnering on a volatility contract called the SPIKES Volatility Index, which competes with the VIX contract. It's my personal opinion that the SPIKES contract has certain advantages over the VIX. For a brand- new product, I think it has reasonably robust volume, and it has a certain market share which, of course, fluctuates from day to day. And that volume is without an associated futures market. The VIX, of course, has a futures market and an options market.

There's every reason to believe that when futures are launched on the SPIKES Index, it should be a reasonably successful product. In a sense, we're actually collaborating with Miami International Holdings on a variety of activities. You should look at the Miami International Holding investment not merely as a deal where we shake hands, take our MIAX shares, and say farewell. There's a larger collaborative effort, which is there for anybody to see. The SPIKES futures launch on the MGEX is planned for November 18, 2019.

Getting back to the MIAX/Bermuda Stock Exchange transaction, the MGEX/SPIKES arrangement demonstrates a larger strategic issue at play. We're not saying farewell to the Bermuda Stock Exchange; we're actually enhancing our position in it. In its current configuration, the Bermuda Stock Exchange does not have, nor could it have had, the resources and the technology of the MIAX. We had to look to a company that had those attributes already and, in my opinion, MIAX has the best technology out there.

Questioner 2

Mention has been made that the company has been buying back stock in the open market. Where does that activity appear in the statement? Does the buyback stock become Treasury stock or are the stock buyback shares cancelled?"

Murray Stahl – Chairman & Chief Executive Officer

While the FRMO board approved a stock buyback program, we haven't yet bought or repurchased any stock. We almost did. There was a seller of stock, and we were thinking of buying back that stock, but in the end it didn't all come to market, so we weren't able to. But we would have bought it if things had worked out differently.

Horizon Kinetics has a 10b-5 plan, which allows it to purchase shares from FRMO on a regular basis. Since we own a piece of Horizon Kinetics ("HK"), in that sense, our ownership of FRMO shares is increasing, but they don't get canceled; it's just that HK owns more shares. I looked the other day, and I think HK now has approximately 182,000 shares. So, on a look through basis, you could say that we are buying shares. But FRMO also has the right to directly buy its own shares, and that might actually happen.

Questioner 3

Could management explain the rationale behind the sale of the shares of Bermuda Stock Exchange to MIAX? In the past, the rationale for these exchanges was a means of gaining access to various asset classes from a unique position in the capital structure of the class. Thus, diversification made sense. Why are we reducing exposure to insurance-linked securities ("ILS") when the asset class is growing so rapidly? Is it a view on the asset class (the table), or is it the operation (the seat) that is driving the decision?"

Murray Stahl – Chairman & Chief Executive Officer

I discussed the Bermuda Stock Exchange in an answer to an earlier question, but I'll go into more depth here. It's certainly not a view on the asset class, and we're certainly not giving up on insurance-linked securities. It's just that, as a small exchange, there's only so much that can be done with the resources you have at your disposal. To become a multi-asset class, larger exchange requires high performance technology, for which a great deal of capital must be raised. It cannot be accomplished with a small amount of money.

I believe that since MIAX was started, hundreds of millions of dollars have been spent on its technology developments, and MIAX continues to invest in technology. Such a massive technology upgrade would have been an enormous commitment for the Bermuda Stock Exchange, and it seemed silly to reinvent the wheel and start from the beginning. They would have been obliged to hire a large number of skilled developers, which would be way beyond the resources of the Bermuda Stock Exchange. Moreover, it would have taken them years to assemble the team and to then develop the technology. Nor, of course, would success have been guaranteed. On the other hand, I think the collaboration between the two exchanges could benefit both.

I want to stress—and that's why I take the liberty of even repeating this part of it—that in no sense whatsoever are we backing away from the exchanges. We're actually increasing our interest. You can see it here. We're not backing away at all. There's just this larger, let's say commonality of interest, if that's the right word, between MIAX and us. I think it's all for the good.

Questioner 4

At the annual meeting, management expressed a view on inflation, that U.S. inflation is running at 5% plus or minus, rather than the official figure, around 2%. Given that nominal GDP is expanding at a rate a bit less than 5%, does management believe that real economic activity in the U.S. is actually contracting?"

Murray Stahl – Chairman & Chief Executive Officer

No, I don't believe that it is contracting. There's a debate as to how you even measure GDP, as noted in SEC Chairman Powell's remarks the other day. For example, how many people on a daily basis do Google searches? Quite a lot, obviously. But they're free. And people wouldn't do them unless they got value from them. So, if that's the case—and we have no reason to believe it isn't the case—how do you measure that value? Because the only things that we can put in GDP are goods and services we can put a price on. What about things we can't put a price on? To what degree does it impact GDP, if at all?

That's the debate going on. No one knows the answer to it. When the GDP calculation was invented, there was nothing like Google. Really, it was a manufacturing economy. We didn't have the computers or the technology that we have right now. So, we're not even sure how to measure productivity properly. That's the problem.

The second problem, separate and apart from this, is that we don't know what the GDP is; that's the real short answer. Therefore, we can't simply take my or anybody else's estimated inflation figure and subtract it from the GDP number and say we're in a recession, because it's not a valid result. But we can make certain assertions about inflation, such as the inflation numbers that are produced by the Bureau of Labor Statistics are hedonically adjusted. Some items rise in price, others don't, maybe others decline in price. We can't just multiply all the price changes by their assigned weights in the basket, sum those up and say, here we are, we have an inflation number. That's not what's done.

Certain assumptions are made. I won't go into it much, because I explained it in detail at the annual meeting so it's in that transcript. What basically happens is that when an item rises in price, one of the many methodological adjustments that are made is an assumption that consumers will substitute a less expensive item for one that rose in price.

At the annual meeting, I used the example of beef and chicken. If the beef prices rose by—I think the example I used was they rose by 25%—and you transferred that purchase to buy more chicken, instead—which in this example didn't rise in price at all—you'd actually have no inflation. There are certain assumptions along these lines that are made in calculating that inflation number that you could debate endlessly.

Why would it be endless, incidentally? Because there's a multitude of items in the CPI Index, and there are other items that are not in the index that you could argue should be in it, and there are some items in the CPI Index that others think are not important enough to be included. Then you could debate what the weights should be. There's a whole series of subjective decisions, literally hundreds, and quite possibly thousands to be made.

From my standpoint, mathematically, aside from not wanting to participate in a debate that will not be, for our practical purposes, resolved, I don't want to base my analysis on subjective decisions. I feel that inflation is related to money supply growth, so I use that as my proxy for inflation. What I use is the M2 figure, which can be found on the St. Louis Fed's website. It is updated every Thursday. As a matter of fact, it probably just came out as we're speaking.

Of particular note is that in the last 12 months, the M2 figure increased by a very large quantity. If you track it from April 22nd to the most recent number, you'll see it's rising at a very high rate. If that continues for much longer, there will be some inflationary pressures. Whether the CPI can pick it up or not is a matter of subjectivity. When you're working with statistics as a mathematical construct, it's not a mere mechanical calculation. The calculation can be mechanically right and give you a very wrong, or shall we say, circumstantially invalid answer.

Here's an example, just so you understand the importance of the subjectivity. On jet aircraft, the probability of engine failure is one out of 100,000. However, there are two engines on a twin-engine jet, so even if one fails, you could still land the jet with one engine. You would only have a problem if both engines fail at the same time. You'd say, okay, the joint probability of one in 100,000 is a very small number, times one in 100,000 and, if I'm doing it correctly, the odds of joint failure are one in 10 billion observations.

All right, so how many times are you going to take 10 billion flights? There's not a lot of people taking 10 billion flights. So, you would say that the probability of both engines failing is extremely small. One would assert that the engine failure events are completely independent of each other because each engine is on a different wing. In practice, though, they're not independent. Why are they not independent? Because the common source of engine failure is that birds get in the engines. If the plane flies into a flock of birds, it's very likely both engines will be compromised.

Steven Bregman – President & Chief Financial Officer

How about Ernie, the mechanic, working on both engines?

Murray Stahl – Chairman & Chief Executive Officer

That might be a factor as well, but I can't speak to Ernie; I don't know him. But you see that by making the subjective assumption that the two events are independent, a radically different conclusion would be reached than if you make the more reasonable assumption, I think, that the events are not independent. Anyway, so you see the problem with statistics. That's why I try to keep it simple.

Questioner 5

Since the company's ownership and participation stakes in Horizon Kinetics (HK) are the largest and most productive assets on the balance sheet, could management provide some commentary on the size, performance, midterm goals, and strategy of HK? Perhaps this could be linked to management's comments elsewhere about how the asset management business is changing or needs to change?

Murray Stahl – Chairman & Chief Executive Officer

Depending on the day, we have between $5.5 and $6 billion under management. That's been a relatively stable number, because much of our asset base consists of individual accounts. The large-scale market in relation to the S&P 500—I think I covered that a little bit earlier—that's not a profitable endeavor. In response, we've been creating specialty products, some of which revolve around selling short certain path-dependent ETFs. We also have some new ideas and new products coming out.

For example, we created a fund around some exchange-traded investments, and we're thinking about designing another one. We're taking the business in the direction of having portfolios that differ radically from the S&P 500. I think the way our standard portfolios have evolved makes them radically different from the S&P 500. Steve, you made an observation the other day about how radically different they are. Maybe you'd like to share that with our callers.

Steven Bregman – President & Chief Financial Officer

Yes. It's one thing for me to sit before a client, or sometimes in a quarterly review, and extemporize about how there's a record low weighting in the S&P 500, for instance, in energy, which is now down to something like 4.5%. Exxon Mobil itself used to be a larger weighting than that. You'll notice a pattern here. We're talking about hard assets or inflation beneficiaries. Although there's a materials sector in the S&P 500, which is one of the smaller sectors, but not insubstantial, you might think of materials as inflation beneficiaries or as having a lot of optionality, but really they're mostly plastics companies, packaging companies, paper companies, and the like.

There's only one gold company in the S&P 500, and it's a small fraction of a percent. There might possibly be an actual base metals mining company, but I'm not sure, and so forth. I can talk about that, and I can talk about our strategic concerns for our portfolios not having resiliency with respect to certain shocks or pressures that might appear in the economy, such as higher interest rates or some kind of commodity price shock. You can talk about that, and how it's important to understand that accounts that have more exposure to depressed industries like shipping, or precious metals, as examples—how they'll behave differently than the S&P 500.

It's one thing to extemporize about it and it's another thing to put before a client, as I did last week a very modest table that shows, for instance, that during the, let's say, 21 trading days in September, how many days their account closed in the opposite direction of the S&P 500. So, if the S&P 500 closed up one day and their account happened to close down that same day, that's an opposite direction. And we count them up and I'll show them that their account closed in a different direction than the S&P 500 50% of the time. I'll tell them that one month is statistically irrelevant. It can't tell you anything about the future, and it's not predictive, it's not reliable. But, nevertheless, they look at that and they see that their portfolios are really positioned very differently than the S&P 500. And that's really important.

In a sense, the last time our portfolios were anywhere close to this different—it doesn't even compare—than the market per se, was back at the end of 1999. And in that case, it was simply that we didn't own the technology stocks; we didn't own any internet stocks; and we didn't own any of the deregulated, high P/E, high growth electric utility stocks. We just didn't own them. By that very fact, we were markedly different than the market. And our accounts benefited from that actual functional differentiation. It was not just a semantic differentiation. Today, the divergence of our portfolios from 'the market' is even greater, and that's the big difference.

It could well be for our business that we'll have another event like that—it could be a month, it could be a year, it could be longer than that, I don't know—when our portfolios begin to act very, very differently than the market and in a very pleasing way for our clients. So much so that it could have a big impact on Horizon Kinetics. You might not be aware, it depends how long you've been students of Horizon Kinetics, but that what happened to us in the wake of the internet technology bubble collapse between the end of 1999 and 2002 or 2003 is that we didn't collapse. That's what happened —we didn't collapse, we were up; that single difference was responsible for our assets under management going from more or less $600 million to some multiples of $6 billion. It could happen again, we don't know. We're just trying to do the right thing.

Questioner 6

FRMO common trades at a price approximately 2x the book value of common equity (net of non-controlling interests). This is due to the immense intellectual capital supplied by management and perhaps due to one or more assets having value in excess of their carrying values on the balance sheet. In order to maintain this ratio, the intellectual capital of the firm has to grow at a rate at least as fast as the growth of the balance sheet equity. How is management working to increase the intellectual capital of the firm?"

Steven Bregman – President & Chief Financial Officer

Well, that sounds a little too mechanical to me. I appreciate the question, but it's a little linear. It would be very difficult. I don't know what your IQ is. I don't want to know. I don't know what mine is. I think it can shade one's perceptions and decision making. But how could you keep increasing it? I don't know if it's possible.

Murray Stahl – Chairman & Chief Executive Officer

Well, to be fair to the questioner, I think what's meant is the knowledge base. I think that's really the sense of it.

Steven Bregman – President & Chief Financial Officer

But I don't think it's necessary. Because you've been focusing on investments that have a very high multiplier in terms of the size, and order of magnitude that they could be if successful. You've talked about this a lot. It's a small investment, if it doesn't work out, it doesn't cost much; but if it does work out, it could be orders of magnitude larger, and I use order of magnitude in the scientific notation sense, larger by a factor of 10. So, of all these elements on the balance sheet, such as MIAX and merely that one contract, the SPIKES and the eventual SPIKES futures, those could be, in principle, and it's not outlandish—it's a matter of resonance, time, place, fortune—but there's no reason those volatility instruments couldn't be every bit as big as the VIX. In which case, the scale relative to the balance sheet is just enormous.

The same could be said about the operations and possibilities at the MGEX. A single successful futures contract—could it be the carbon trading? Could it be something else? Could it just be the continuation through its market saturation of the proper volumes for it in grain? Mining cryptocurrency could ultimately be orders of magnitude greater. Any one of the seeds that already exist have that possibility, even without any additional intellectual capital expansion.

Murray Stahl – Chairman & Chief Executive Officer

If you look at the cryptocurrency effort in detail, you'll see that we've made small investments in hosting, and in the cryptocurrency itself, and in cryptocurrency mining, and in funds. We've been testing the waters in every area of cryptocurrency and, in the next quarter, we'll be testing more areas that you'll learn about in the next quarter. There'll be some new items that you'll learn about.

In no case do we really commit that much capital to it. If it's a complete and utter failure after taxes, it won't really make a difference. However, ultimately, assuming it's successful, it will be a business. If it's a business, it will be an operating business. If it's an operating business, there will have to be more people here to operate it. What will happen, assuming it goes that way, is there might be more people besides us working in the company. That's as it should be really because nobody knows everything, and to take the company to the next higher level might require some other human resources. We're only two people, and we can only take it so far. We're in the initial stages of cryptocurrency.

One of the reasons we have this big cash balance on the balance sheet is that we were always looking for businesses to buy. The only restriction we really had on it, other than that we had to be able to afford it, was that it had to be something in our circle of competence. Had we bought something, we would obviously be part of that company and, by definition, we'd have a lot more employees. It just so happens that we were doing this within an era of exceedingly low interest rates. For anything that we would have bought, we would have had to pay a control premium, and it would have been really expensive.

You can find businesses with very robust returns on capital, and you can debate how durable that ultimately is. If something is really durable, and assuming the same people were willing to stay to run it on a daily basis, we would have been paying top dollar for it. There's no way around it. It was just very hard to envisage how we could earn a return as robust as we earned on our capital.

Let's go back to the balance sheet. Let's say, in round numbers, we made, just in equity appreciation, a million dollars from May 31 to August 31. And that's without taking the mark-to-market gain on Bermuda, and that's with the GAAP tax charge. So, if you add those things in, I think it doesn't take a lot of imagination, we'd at least have $3 million-plus of appreciation. But almost half of our assets are in cash. We're really talking about $3 million appreciation on roughly $60 million of truly invested assets. And some of those invested assets we don't even mark to market—that are probably worth more, one such example being Digital Currency Group. But there may be a limit to continued asset appreciation of, let's say, $3-ish million on $60 million. That's 5% in the quarter. If we kept doing that, it's a 20% return on equity. That's really a great thing to do.

How were we going to be able to continue that if we paid top dollar for a company—if we had to pay 30-plus times earnings for a company? Even if everything worked out famously, it would take years before we even got a payback. That was the problem.

The answer, it turned out, was if we can't find what we want or we haven't been able to find it thus far, we have to create it. It has to be within our circle of competence. And we felt that cryptocurrency, as bizarre as the statement might sound, because no one really knows cryptocurrency, is something we could really understand. And we also saw how little other people understood even the basics, even the terminology, which means we could have an information advantage. So, we got involved in it. Even the mining process alone can illustrate—the way people talk about cryptocurrency without reference to the mining economics, shows that this is a field, at least from the popular understanding of the subject, that the world really doesn't understand.

Just to give a highlight: if you want to own a bitcoin, you can do it one of two ways. This is going to be like a mini tutorial on crypto, and maybe it'll give you a sense of why we decided this is the thing for us. I should say at the outset, you can do it in small increments. You could invest a few thousand dollars and if it doesn't work—even if it is an unmitigated disaster—it's only a few thousand dollars. The other investments required either that you be all in or not in. You would be taking a big risk, and we didn't want to take a big risk. That was part of the decision making process.

So, if you want to obtain a bitcoin, you have a choice: you can buy one or you can mine one. If it's not cheaper to mine it, no one would mine it; they would just buy it. By definition, I think it's fair to say, it has to be cheaper to mine than to buy, because otherwise who would put up with all the problems you would normally encounter in mining? And it's a lot of work, frankly.

The mining, to a very large extent, in the short run, controls the price. Why? Because when there's an improvement in mining technology, it dramatically lowers the cost. Let me explain. I'll give you an actual example. I'm going to do it slowly, because I'm going to give you some numbers, and I don't want you to miss any.

In bitcoin mining, the go-to machine until mid-2019 was the Bitmain S9. It's a 14 terahash machine, and it draws something like 1400 watts. Now, they have a T17e 53 terahash rig, and the approximately 70 terahash S17+, which is considerably more than 14, obviously. And it draws—I'm relying on memory, I hope this is going to be right—it draws approximately 2,800 watts. It might even be less. Anyway, if you divide that, you're now using a lot less power per computation. So, the cost of operating your machine is going down a lot.

By the way, people are getting better at making these machines, and they are getting cheaper as well. That's a factor, and is one of the reasons that we don't invest the money rapidly, because we don't want to be caught with a lot of obsolete equipment. We build up a certain amount of cash flow, we pay out a dividend, and we husband the cash flow to buy the next generation of machines, which generate even more cash flow. Anyway, that's neither here nor there.

You can clearly see in that instance that you have a considerable margin of safety. If you buy a few machines, even for some tens of thousands of dollars, and you make a mistake, it's not fatal. Life will continue as it is. Ultimately, it's a cycle. When the price of the machine goes down, theoretically it will be more profitable to mine bitcoin. But this doesn't happen in isolation; it occurs within its own marketplace. Because, of those who have a choice between owning a bitcoin—even buying it in the open market—or buying a machine to mine it, many will decide to sell their bitcoin and buy the machines. When they sell the bitcoin to fund their purchase of new machines, that's the mechanism by which the price of bitcoin goes down. In a way, it reflects people's preferences. They'd rather own machines than own bitcoin.

The machines are not like an arbitrage in the market. It takes time to get the machines, install them somewhere, test them, download the software, get them delivered, and so on. It takes months, there's no question about it. And right now, it's particularly hard because there's a tariff on goods from China. The chips are made in Taiwan. They're assembled in the People's Republic of China. There's no tariff from the United States on goods from Taiwan, so you can get the chips and assemble them yourself, but that takes a certain amount of labor that you really don't want to be involved with.

If someone were buying just one machine to test it, a tariff wouldn't make a difference. They might buy it anyway just to be able to test it and get the information. But, for those who buy a large number of machines, no one wants to pay the tariff. That's why the manufacturing companies are in the process of moving to Malaysia. There's no tariff there. If I were to order equipment today, if I'm lucky, I might get it the first or second week in January. That's if I'm lucky, and I don't think I'd be lucky.

Anyway, that gives you a sense of what's going on there in that business. What will ultimately happen is that the equipment will be better and far more durable than the equipment was before. It will probably last longer and have a much lower operating cost. In the fullness of time—whether that's months or longer—there will be a lot more terahash mining bitcoin. I have no doubt whatsoever. The more terahash there is in the long run, the higher the price, because there will be more machines competing for each bitcoin.

You'll have better machines, with a lower operating cost, but you'll have to share the reward across a lot of machines, so you'll gain less revenue per machine, which drives up the price of bitcoin. In the short run, it might drive the value down but, in the long run, it drives the value up. That's the process. That's why bitcoin is so volatile. There might be a day when you'll see bitcoin drop 12% or 15% in a couple of minutes. The general reason why that happens is one or more sets of machines just got a lot cheaper.

But most people don't have access to that information, so they can't consider it in their analysis of cryptocurrency. By the way, the reason all the cryptocurrencies are correlated is that even though there are different types of machines to mine different coins, not all the currencies are mineable. In fact, most of them are not. The mineable ones represent the bulk of the market capitalization of all the cryptocurrencies. If there's a technological advance in one kind of machine—let's say, a heat sink that causes the machine to generate less heat or something that improves power consumption—it can be applied in very short order to all the varieties of machines, to a greater or lesser extent. And that's why they are all so correlated. Eventually, we'll get to the point where the mining rigs will have improved to the degree that there aren't further radical changes, and then the crypto is going to be a lot more stable. Anyway, that's the tutorial.

Getting back to what we were looking for in a business, we were looking for an operating business, but we didn't want to expend our cash for a very high- priced entity and then realize we made a mistake. What would we do then? Look at how many years it took to accumulate that cash. We decided to spend very little money which, given our current earnings, we could replace very quickly, and whatever we might lose would be a tax deduction anyway. Such a loss certainly would not be meaningful relative to our equity base, and it's a learning process as well. Once we figure out which aspects of cryptocurrency we want to concentrate on, it will be one operating division. We're still studying how we will do that, and when we will do it, and what form it will take.

At that point, there'll be an investment division and there'll be an operating division. If the operating division wants funds to expand into some activity, the investment division will decide whether they want to give them the capital. When the operating division makes money, most of that capital will be repatriated back to the investment division. If the operating division needs it, it will be available to them, as long as the purpose makes sense. That's how we intend to do it. I hope that tells you something about intellectual capital and how we use it. We've encountered a fair number of highly intelligent people, and maybe one day they'll be part of this enterprise.

Steven Bregman – President & Chief Financial Officer

I have a further thought. The questions regarding value creation or optionality puts me in mind of the internet bubble and one of the very first internet value stocks that you came across before a fever came upon the land that became the internet bubble. We had, and still have, a mutual fund called the Internet Fund. Being of a value-oriented bent, we were thinking: "Where can we find something in this new internet stuff?" This was back in 1995 or 1996.

It was still possible, at the time, to buy value stocks among the array of internet stocks. One of the very first was a company called CMGI, which became a darling of the Internet Bubble era. CMGI stood for College Marketing Group. Basically, it consisted of two guys who had run this business for a long time. They had a lock on the high school and college ring market.

They got hold of the year books or lists of the graduating class from the schools, and they would go to the schools and sell them rings. They had that business, and they made a lot of cash, but the business didn't require any investment, so they accumulated a lot of cash. Young internet entrepreneurs would go to them to get funding for their projects and, in return, CMGI would get shares of these start-up companies.

Eventually, CMGI had all this cash, the ongoing earnings from its legacy school ring market, and a whole string of options, in a sense, within the company. Some were older and developing, and some were newer and still semi-formed. They didn't know if they would be successful or not. At the time that we originally purchased this stock, a couple of their tech holdings had come public. At the time, this company was worth less than the sum of its cash on the balance sheet, and the market value of just one of their newly public companies, which I think was DoubleClick. The rest was free. Given that particular calculus, you got all these other extra options in the bargain.

Relative to this question, I think about the Miami International Holdings SPIKES Volatility Index, or what's going on at the MGEX, including the possibility of a successful hit with a carbon trading contract, or with the cryptocurrency mining, or with Texas Pacific Land Trust. If we have a $300 million market cap at FRMO right now, and let's say for the sake of argument we own, roughly, $25 million of TPL, what if TPL becomes worth five times more? That right there would add one-third to the market value of the company. It would be $125 million extra. If it was worth ten times more, it'd be $250 million.

We own $6 million worth of bitcoin. What if it goes up merely 100 times? That's $600 million. That's twice the market cap of the company. The questioner asked about why we trade at 2x book. Maybe some people look at FRMO like we looked at CMGI, like a metaphorical string of pearls, and each pearl is a different option. The optionality in much of what you have put together is enormous for any one of these. They don't all have to hit. Anyway, that's my extra two cents.

Murray Stahl – Chairman & Chief Executive Officer

Thank you, Steve.

Well, we don't want to exhaust your patience, so I want to thank everybody for being on this call and, of course, we will reprise this in the next quarter. We look forward to working with you on an ongoing basis. We're grateful for the questions, because they were really good. We'll keep doing what we're doing, and we'll report back to you in about 90 days. Thanks so much.

Operator

Thank you all for your attention. This concludes today's conference. All participants may now disconnect.

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