



Steve Patton and Mark Harms

Patton Investments

In the first nine months of 2008, a total of 693 hedge funds closed up shop, according to data from Hedge Fund Research, a Chicago-based information company. In November of 2008 alone, investors pulled \$32 billion out of hedge funds, making it the first year on record that these funds have seen a significant outflow of money.

The news has been dire for hedge funds, so it seems odd, even risky, to start a new hedge fund right here in Madison. That, however, is what Steve Patton and Mark Harms have done, and they don't seem at all nervous about their new venture.

In fact Patton (42), who has been managing investments for private individuals since 1999, said he's been holding back for years, waiting for this moment to make his move.

"I liked what I was seeing in the market about a year ago," recalled Patton. "The storm clouds were gathering – something I'd been predicting for ages, and I specialize in this type of climate. I did okay during the go-go days, but this is the kind of market where I really excel."

The growing economic crisis prompted Patton to act fast. He convinced Harms, an old friend from triathlons, to leave his current position as an operations scientist at Promega and join him in the new venture. He registered Patton Investments as an LLC and rented office space, then Patton and Harms got busy gathering investors for their

new fund, which launched early last month.

A hedge fund is a private investment fund limited to 100 accredited investors. Accredited investors may include investment banks, foundations and nonprofits, and high net worth individuals. A corporation or charity can be an accredited if it has more than \$5 million in assets and an individual is "accredited" if he has a net worth of more than \$1 million, or has earned more than \$200,000 each of the last two years.

There is one other hedge fund in Madison, run by Nakoma Capital.

Hedge funds don't rely on the health of the market the way most other investments do, because hedge fund managers usually "hedge" their investments in creative ways, most notably short selling, the practice of selling a "borrowed" stock or other financial instrument with the hopes that the stock will decrease. This allows the seller to buy it back for less and make a profit when it is sold back to the original owner. In recent years, use of the term hedge fund has become lax and it's often applied to any private investment fund, whether the fund hedges or not.

Hedge funds are, for the most part, unregulated by the SEC, though there are a few rules: hedge funds are not allowed to advertise, nor are its managers allowed to promote the fund. Harms and Patton weren't allowed to disclose the name and number of current investors in their hedge fund, the amount now in the fund, or even the exact name of the fund.

Patton, founder, president and the math brain behind the fund, is from Pittsburgh and got his degree in quantitative finance from the Wharton School of the University of Pennsylvania. He interned on Wall Street in the late 1980s, and later worked on the ground floor of several successful start-up hedge funds, including Stark Investments in Milwaukee.

Harms (33), who is in charge of operations, has a Masters in biotechnology from UW-Madison. In his spare time, he trains to keep up his title as the number two triathlete in the world in his age group.

Patton used his prior investment connections to get the hedge fund started, and he and Harms held several invitation-only breakfasts last year to gather more support. While Patton can't reveal his exact number of

current investors, he said, "Let's just say we have more than five and less than 100."

The typical fee structure for hedge fund managers is "2 & 20," meaning the fund takes a two percent management fee and 20 percent of any profits. The fund at Patton Investments, according to Harms, is comparable to the majority in this respect.

Patton's unique investment model is what makes him feel so confident despite the dour market. His fund uses arbitrage – bonds that can be converted into shares – a model that is fairly unique and not used by many other funds worldwide.

Patton described himself as "quanti," which, Harms explained, means he's quantitative, or good at math. No, Patton didn't just make that word up. "Quants" is a term used to refer to hedge fund operators who take a particularly brainy approach, rather than a brawny, blustery one, using long and complicated algorithms to conquer the complex whims of the market.

The two owners definitely give off more of a brainy than brawny vibe. Both are confident but soft-spoken. Their offices are clean and spare, decorated by plants and pieces of original art. Classical music plays.

Patton, who said he gets many of his ideas on long bike rides, has a white board up almost completely covered in neat, complicated equations. "That's the formula I'm working on for the fund," Patton explained, pointing to the board. He often uses a Ph.D. math intern to help him work out any kinks in his vision.

Patton looked at the board as if it told a story, and said, "I like buying things cheap. I like when there are no other buyers around and I have my pick. I wouldn't say we're all the way there yet, but we're coming up to that time. This is what I've waited my whole career for."

PATTON INVESTMENTS

BUSINESS LOCATION:

725 Heartland Trail #203, Madison 53717

PHONE: (608) 831-1820

WEB: www.pattoninvestments.com

EMPLOYEES: 2 FT / 6-16 UW interns-varies

HIRING GOALS: Patton plans to hire one full time quantitative researcher and one full time accountant in the first half of 2009.

"Ultimately, I'd like to cap the company at 20 employees," said Patton.