

**FORM ADV Uniform Application for Investment Adviser Registration
Part 2A: Investment Adviser Brochure
Item 1: Cover Page**

**Hearthstone, Inc.,
a California corporation**

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*This brochure provides information about the qualifications and business practices of
Hearthstone, Inc. If you have any questions about the contents of this brochure, please contact us at
the phone number listed above.*

*The information in this brochure has not been approved or verified by the United States Securities
and Exchange Commission or by any state securities authority. Please note, where this brochure
may use the terms “registered investment adviser” and/or “registered”, registration itself does not
imply a certain level of skill or training.*

*Additional information about the firm and its representatives is also available on the SEC’s website
at www.adviserinfo.sec.gov*

Item 2: Material Changes

There are no material changes that are required to be reported for fiscal year 2015.

Updates to the information contained within this brochure will be provided to clients on an immediate basis. This section will be updated to reflect such changes in a summary form. Should you have any questions related to these disclosures, please contact a firm representative at your convenience.

Additional information about Hearthstone, Inc. and its representatives is also available on the SEC's website at www.adviserinfo.sec.gov

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Item 4: Advisory Business

Hearthstone, Inc., a California corporation (“Hearthstone”), is, and always has been, in one business only – investments in single-family homebuilding and development. The sole shareholder is Mark Porath, Chief Executive Officer. In 1992, *Hearthstone* pioneered the concept of pension fund investing in residential development and homebuilding and was one of the first sources of institutional capital dedicated exclusively to this sector. Since that time, through 19 previous investment funds, *Hearthstone* has financed the purchase and construction of over 122,000 residences and lots in 475 separate communities spread across 100 markets and 20 states. For the benefit of its clients, *Hearthstone* has financed projects sponsored by over 40 homebuilders and funded investments exceeding \$13.3 billion in total value.

Investments include land acquisition, development and construction projects, single-family home, condominium and townhome projects, and unentitled land projects. In most circumstances, *Hearthstone* is required to obtain the client’s approval prior to making an investment. Investments are typically structured with interaction between five entities:

- 1) ***Project Owner*** – The *Project Owner* can be either a limited liability company (“LLC”) or a limited partnership (“LP”). It directly owns the actual project, whether it is a lot option (also known as “landbanking”) project involving the financing of land development, a homebuilding project involving the financing of land development and the construction of homes, or a land development project. In a homebuilding or land development project, the *Project Owner* is owned by the *Builder Partner*, the *Investment Fund*, and the *Managing Entity*. In a landbanking project, the *Project Owner* is owned by the *Investment Fund* and the *Managing Entity*. However, if the *Project Owner* is an LLC, the *Managing Entity* has no ownership stake. In the case of a lot option project, the *Project Owner* grants to the *Builder Partner* an option to purchase residential lots and the *Builder Partner* agrees to complete certain land development improvements. In the case of a homebuilding project, the business plan of the *Project Owner* is to develop the land and construct, market and sell homes on the land.
- 2) ***Builder Partner*** – The *Builder Partner* is the residential builder or developer selected to construct the project.
- 3) ***Investment Fund*** – The *Investment Fund* is an LLC. It is generally 1% owned by the *Professionals Entity*, as managing member, and 99% owned by investors. Investors buy membership units of the LLC and receive a share of the profits or losses of the projects based on their share of ownership. The *Investment Fund* is

also part owner of the *Managing Entity*. The *Investment Fund* is a private fund available to only Qualified Clients. A Qualified Client is qualified under Section 205-3 of the Investment Advisors Act of 1940 to invest in private placements and be subject to performance-based fees. Generally, in order for a client to be deemed "qualified", the client must either have a net worth of at least \$1.5 million or have at least \$750,000 invested with the investment advisor.

- 4) ***Managing Entity*** – If the *Project Owner* is an LP, the *Managing Entity* is an LLC owned by the *Investment Fund*, with *Hearthstone* as the manager. If the *Project Owner* is an LLC, the *Managing Entity* is *Hearthstone*, as the manager of the *Project Owner*.
- 5) ***Professionals Entity*** – The *Professionals Entity* is an LP. It is owned solely by *Hearthstone*, as the general partner, and the owner and certain current and former employees and consultants of *Hearthstone*, as limited partners. The *Professionals Entity* is also generally a 1% owner and managing member of the *Investment Fund*. The *Professionals Entity* receives a commensurate share of the project's profits or losses. The *Professionals Entity* can also receive *Base Management Fees* and *Incentive Fees*. *Hearthstone* does not receive *Incentive Fees* but does receive a portion of the *Base Management Fees* from the *Professionals Entity*.

Hearthstone manages all of its investments. In addition to managing assets held by *Hearthstone*-sponsored funds, *Hearthstone* also manages residential assets for pension funds and private businesses. *Hearthstone's* advisory relationships are negotiated on a client-by-client basis and tailored to the investment requirements of each client.

Investors of *Hearthstone* invest in one or more *Investment Fund*. Each *Investment Fund* may invest in one or more projects. Except in limited situations, *Hearthstone* is required to obtain the client's approval prior to adding a project or projects to an *Investment Fund*. Each *Investment Fund* and each investor will make a capital commitment to fund one or more projects. During the development of a project, capital calls will be made to the investors in order to meet current and short-term expenses. In no event will capital calls exceed the previously stated capital commitment.

Assets under Management: As of the date of this filing, *Hearthstone* manages a total of \$393 million in client assets. Assets are internally valued using generally accepted accounting principles.

Item 5: Fees and Compensation

Typically, a project generates two (2) types of fees – a *Base Management Fee* and an *Incentive Fee*.

Base Management Fee - The *Base Management Fee* is typically calculated as a percentage of projected revenues or as a percentage of actual project costs. This is paid by the *Project Owner* to the *Professionals Entity*. In some situations, a portion of the management fee is paid by the *Investment Fund* to the *Professionals Entity*. Typically, this fee is paid monthly and amortized over the life of the project. The *Professionals Entity* pays a portion of the *Base Management Fees* to *Hearthstone*. The specific terms, conditions, and payment schedule of each *Base Management Fee* is described in the *Investment Fund* operating agreement and the development agreement between the *Project Owner* and the *Builder Partner*.

Incentive Fee - The *Incentive Fee* is an additional distribution of profits paid from the *Investment Fund* to the *Professionals Entity*. It is contingent on the *Investment Fund* realizing a stated internal rate of return (“IRR”). The specific terms, conditions, and calculation of an *Incentive Fee* are described in the operating agreement for each *Investment Fund*.

On a quarterly basis, the cash requirements of the *Investment Fund* are analyzed to determine if there is sufficient cash on hand to meet any pending or future capital calls. If sufficient cash is on hand, a portion of the profits from a project may be distributed to the individual investors in the *Investment Fund*.

Item 6: Performance-Based fees and Side-by-Side Management

As described earlier, there is one fee that can be considered performance-based – the *Incentive Fee*.

The *Incentive Fee* is an additional distribution of profits paid from the *Investment Fund* to the *Professionals Entity*. It is contingent on the *Investment Fund* realizing a stated IRR. The specific terms, conditions, and calculation of an *Incentive Fee* are described in the operating agreement for each *Investment Fund*.

Because the *Professionals Entity* receives a management fee based on projected revenues or costs, not profits or returns, the *Professionals Entity*, and its general and limited

partners, could be incented to use their discretionary authority to invest in projects with high revenues or costs without regard for their profitability.

It should be noted that, generally, no two *Investment Funds* make investments in the same project type so there is no competition for investments between *Investment Funds*.

Item 7: Types of Clients

Hearthstone investors primarily consist of pension funds, university endowments, Fortune 100 companies and large private trusts. Minimum investments are determined within each *Investment Fund* and are available only to Qualified Clients.

Item 8: Methods of Analysis, Investment Strategies, and Risk of Loss

Hearthstone has a consistent process and methodology to approve financing opportunities.

Before becoming an approved *Builder Partner*, each *Builder Partner* is subject to a comprehensive financial and operations review including the review of the *Builder Partner's* track record, financial condition, trade and credit references, and insurance loss history.

Builder Partners submit proposed projects to *Hearthstone's* Land Committee for consideration. Qualified *Hearthstone* employees tour the proposed development site and prepare a preliminary due diligence memorandum that summarizes the project and includes a pro-forma showing expected revenues, costs and potential profit. This is submitted to the Land Committee for preliminary approval. If the project receives preliminary approval, *Hearthstone* engages consultants to perform a comprehensive due diligence review of the project and to prepare a summary of their findings. A *Hearthstone* employee will prepare a final report for the Land Committee that includes identification of potential risks, suggestions to mitigate or eliminate those risks, a project budget, schedule and final pro-forma. The final report is submitted to the Land Committee for final financing approval.

Hearthstone seeks to diversify an *Investment Fund's* investments. Projects typically are diversified by market, *Builder Partner* and product type.

Risks of Investment

The purchase of interests in the *Investment Funds* involves certain risks. The risks set forth below include some, but not all, of the risks that may affect an investment in the *Investment Funds*.

Investment Risk: Any investment in a project is subject to loss of funds invested. The projected profitability of a project is not a guarantee of its performance.

Liquidity Risk: *Investment Funds* are reviewed quarterly in order to determine if profits are available to return to investors in cash. There is no guaranty that cash will be distributed to an investor and, as a result, the liquidity requirements of an investor may not be met. Investors do not have the right to withdraw from the *Investment Fund*. Additionally, each investor is committed to make capital contributions to the *Investment Fund* up to the amount of its capital commitment to the extent necessary to meet the capital requirements of the projects that the *Investment Fund* owns.

Valuation Risk: Since investments in the *Investment Fund* are not independently valued, but are internally valued according to generally accepted accounting principles, the value of a project at any given time may not be its liquidation value.

Partnership Risk: Each project depends to a large degree on the skill, expertise, and financial strength of the *Builder Partner*. Personnel changes, unforeseen liabilities, mismanagement of funds of or by a *Builder Partner* or financial difficulties of a *Builder Partner* that might result in the bankruptcy or inability of the *Builder Partner* to continue its operations could have an adverse effect on the profitability of the project or projects in which the *Builder Partner* participates.

Cyclical Risk: The real estate market is cyclical and subject to fluctuation. Higher interest rates, tight credit, over-development in an area in which a specific project exists, continued adverse general economic conditions (including recession, inflation, slow job growth and continuing high levels of foreclosure), reduced government intervention in the homebuilding markets and a drop in home buyer confidence are among the factors that impact the real estate market. A project may commence during a time when the real estate market is in a cyclical up-turn, but the cycle may turn down during the project. This can have an adverse impact on the profitability of the project.

Land Development and Construction Risk: Investments in residential land development and homebuilding involve significant development and construction risks, such as the risk that the cost of developing the land or building the homes may run over budget and erode or eliminate profit, among others. Cost overruns can occur during any stage of development and/or construction. In the sales phase, delays in sales may lead to

higher costs and fewer projects being selected for investment. Any of these factors could have an adverse impact on the profitability of the project.

Product Liability Claims: The *Project Owners* may be subject to lawsuits and judgments in connection with latent construction defects in the homes constructed. The statute of limitations for such claims may be ten years or longer in certain states or may be tolled in certain circumstances, resulting in an extended period during which litigation could arise. High litigation costs, costs of defense and ultimate costs of judgment could result in lower returns or the complete loss of an investor's investment. Additionally, if distributions are made to an investor prior to the expiration of all applicable statutes of limitation, an investor could, in certain instances, be liable for the return of those distributions, even after the expiration of the term of the *Investment Fund*.

Limited Financial Resources of the Professionals Entity and Hearthstone: *Hearthstone* and each *Professionals Entity* have limited financial resources. If the capital requirements of *Hearthstone* or a *Professionals Entity* exceed its capital resources, it could be exposed to bankruptcy. The bankruptcy of a *Professionals Entity* or *Hearthstone* could adversely affect the *Investment Funds* and thus the investors' investments. *Hearthstone* pays its ongoing overhead costs out of the *Base Management Fee*. The *Base Management Fee* may not be sufficient to cover all of these demands due to reasons such as higher than expected expenses and fewer projects, among others. If the *Base Management Fee* is insufficient to pay *Hearthstone's* operating costs, *Hearthstone* may be forced to discontinue its operations. If *Hearthstone* discontinues its operations, other entities not affiliated with *Hearthstone* might manage the *Investment Funds* or the *Investment Funds* could be liquidated.

Item 9: Disciplinary Information

Under Rule 206(4)-4 of the Investment Advisers Act of 1940, investment advisers are required to provide clients with disclosures as to any legal or disciplinary activities deemed material to the client's evaluation of the adviser. *Hearthstone* and its personnel are not subject to any reportable disciplinary, regulatory, criminal, civil, or other such activity at this time.

Item 10: Other Financial Industry Activities and Affiliations

Hearthstone and its related persons have no other industry affiliations or activities.

Item 11: Code of Ethics, Participation or Interest in Client Transactions and Personal Trading

As required by Rule 204A-1 of the Investment Advisers Act of 1940, *Hearthstone* has adopted a Code of Ethics that sets forth the basic policies of ethical conduct for all managers, officers, employees, and consultants of *Hearthstone*. The Code of Ethics describes the firm's fiduciary duties and obligations to clients, and sets forth the firm's practice of supervising the personal securities transactions of employees who maintain access to client information. A copy of the Code of Ethics is available for review upon request.

Hearthstone and its affiliates have formed and provide management and advisory services to different *Investment Funds*. Owners, employees, and consultants of *Hearthstone* are indirect investors in these *Investment Funds* by virtue of their ownership interest in the *Managing Entity* or the *Professionals Entity*. As a result, the interests of *Hearthstone* may not be the same as those of the investors. The different *Investment Funds* may compete with each other for (i) potential new investments, (ii) access to *Builder Partners* and (iii) the services and resources of *Hearthstone*. Additionally, conflicts of interest may be present as a result of *Hearthstone* and its affiliates receiving multiple and different fees, indirectly acting as an investor in the *Investment Funds*, acting as the general partner or managing member of *Project Owners*, and acting as an advisor and consultant to the *Investment Funds* and the *Project Owners*. To mitigate the potential for conflicts of interest, subject to certain limited exceptions, no two *Investment Funds* make investments in the same product type at one time.

Item 12: Brokerage Practices

In certain circumstances, *Hearthstone* maintains discretionary authority over the selection of projects and the investment of client funds in an *Investment Fund*. However, in connection with the formation of each *Investment Fund*, clients have the opportunity to establish investment standards governing the type of projects in which the *Investment Fund* can invest and the amount of the investment.

All cash invested and available for investment in an *Investment Fund* or project is held by a qualified custodian, such as a bank or broker/dealer. The selection of the qualified custodian is at *Hearthstone's* discretion.

Hearthstone does not receive any soft dollars or other compensation from the qualified custodians used.

Item 13: Review of Accounts

Senior management of *Hearthstone* reviews each project at least quarterly and in connection with this review updates its anticipated future cash flows.

At least quarterly, investors in the *Investment Fund*, receive unaudited financial statements for the *Investment Fund*. At the end of each fiscal year, each *Investment Fund* is audited by independent public accountants. All investors receive a copy of the audit within 90 days of the end of the fiscal year.

Item 14: Client Referrals and Other Compensation

Hearthstone does not compensate others for client referrals or limited partner investors.

Item 15: Custody

All investment assets are held by qualified custodians such as banks or broker dealers. *Hearthstone* is deemed to have custody of client funds by virtue of its investment in the *Professionals Entity*, which acts as general partner or managing member of the *Investment Fund*. As such, *Hearthstone* complies with the annual audit requirements. See the section titled “Review of Accounts”.

Item 16: Investment Discretion

As mentioned in Item 12, in certain circumstances, *Hearthstone* maintains discretionary authority over the selection of projects and the investment of client funds in an *Investment Fund*. However, this discretion may be subject to specified investment objectives, guidelines, or limitations previously set forth by the limited partner investor.

Item 17: Voting Client Securities

Since *Hearthstone* does not use registered securities as investment vehicles, *Hearthstone* does not vote, nor advise clients how to vote, proxies for securities held in client accounts.

Item 18: Financial Information

Under Rule 206(4)-4 of the Investment Advisers Act of 1940, investment advisers are required to disclose certain financial information about their business practices that might serve as material to the client's decision in choosing an investment adviser. See Item 8 under the heading "Limited Financial Resources of the Professionals Entity and Hearthstone."

As of the date of this filing, *Hearthstone* does not require the pre-payment of any fees.

Miscellaneous

Privacy: *Hearthstone* generally prohibits the disclosure of any client-related non-public personal information as collected by the firm throughout the client/firm relationship. However, the firm may make limited disclosure of such information as authorized by the client, or as otherwise provided by law.

Business Continuity: As a registered investment adviser, *Hearthstone* maintains a business continuity plan in the event of a disruption in business. Among other issues, the plan details how clients may access their accounts in the event of an emergency. A copy of the plan is available for review by request.