

**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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**SEC File No. 801-55793**

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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](http://www.adviserinfo.sec.gov)*

## Item 2: Material Changes

There are no material changes that are required to be reported for fiscal year 2020.

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](http://www.adviserinfo.sec.gov)

## Item 3: Table of Contents

Topic	Page #
<b>Item 1:</b> Cover Page .....	1
<b>Item 2:</b> Material Changes .....	2
<b>Item 3:</b> Table of Contents (this page) .....	2
<b>Item 4:</b> Advisory Business .....	3
<b>Item 5:</b> Fees & Compensation .....	5
<b>Item 6:</b> Performance-Based Fees and Side by Side Management .....	5
<b>Item 7:</b> Types of Clients .....	6
<b>Item 8:</b> Methods of Analysis, Investment Strategies, & Risk of Loss .....	6
<b>Item 9:</b> Disciplinary Information .....	8
<b>Item 10:</b> Other Financial Industry Activities & Affiliations .....	9
<b>Item 11:</b> Code of Ethics, Participation or Interest in Client Transactions, & Personal Trading .....	9
<b>Item 12:</b> Brokerage Practices .....	9
<b>Item 13:</b> Review of Accounts .....	10
<b>Item 14:</b> Client Referrals & Other Compensation .....	10
<b>Item 15:</b> Custody .....	10
<b>Item 16:</b> Investment Discretion .....	10
<b>Item 17:</b> Voting Client Securities .....	10
<b>Item 18:</b> Financial Information .....	11
<b>Miscellaneous:</b> .....	11

## 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 35 previous investment funds, *Hearthstone* has financed the purchase and construction of over 121,000 residences and lots in 546 separate communities spread across 100 markets and 20 states. For the benefit of its clients, *Hearthstone* has financed projects sponsored by over 100 homebuilders and funded investments exceeding \$15.0 billion in total value.

Investments include land acquisition, development and construction projects, single-family home, condominium and townhome projects, and unentitled land projects. *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. In some cases, 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 employees 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* also receives *Management Fees* and *Incentive Fees*, if earned. *Hearthstone* also receives *Incentive Fees*, if earned, and some or all of the *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 are 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. *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 obligations. In no event will capital calls exceed the agreed to capital commitment.

**Assets under Management:** As of the date of this filing, *Hearthstone* manages a total of \$793.1 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 *Management Fee* and an *Incentive Fee (aka Promote or Performance Fee)*.

**Management Fee** - The *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 some or all of the *Management Fees* to *Hearthstone*. The specific terms, conditions, and payment schedule of the *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*.

The cash requirements of the *Investment Fund* are analyzed on a monthly basis 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*.

It should be noted that, generally, no two *Investment Funds* make investments in the same project so there is no competition for investments between *Investment Funds* (see Item 11 – Round Robin Format).

## **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. Only projects in certain primary markets are considered based on supply demand characteristics, proximity to job centers, strong schools and transportation corridors and affordability including FHA loan availability. Qualified *Hearthstone* employees tour the proposed development site and prepare a preliminary due diligence memorandum that summarizes the project and includes a proforma 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 proforma. 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 monthly 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 carried at lower of cost or market 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), and a deterioration of 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. 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 repose 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.

Although generally covered by insurance, 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 repose, 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 *Management Fee*. The *Management Fee* may not be sufficient to cover all of these obligations due to reasons such as higher than expected expenses and fewer projects, among others. If the *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* is a member of the Urban Land Institute and has 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 *Hearthstone* 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, *Hearthstone* follows a Round Robin Format to allocate investments to *Investment Funds*.

## **Item 12: Brokerage Practices**

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. 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 unless the investor unilaterally waives such audit. 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 engaged Steven Mastrovich, dba Redimere Advisors, LLC (collectively, “Mastrovich”) to perform brokerage services in 2020. Mastrovich and Redimere are affiliated with Hollister Associates, a registered broker-dealer. During the reporting period, Mastrovich was duly registered as a securities broker with the U.S. Securities and Exchange Commission and under any applicable state securities laws and was a member in good standing of the Financial Industry Regulatory Association (“FINRA”) and the Securities Investor Protection Corporation (“SIPC”). All personnel who acted on behalf of Mastrovich in the performance of services for *Hearthstone* were duly registered with FINRA and under any applicable state securities laws as agents during the reporting period. Mastrovich had limited mandates to discuss investments in new *Investment Funds* only with non-public investment companies approved by *Hearthstone*, pursuant to exemptions provided under the Securities Act of 1933 and the Investment Company Act of 1940, as amended. Mastrovich is paid by *Hearthstone* based on assets under management (at cost), pursuant to a written agreement with *Hearthstone*.

#### **Item 15: Custody**

All investment assets are held by qualified custodians such as banks. *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**

*Hearthstone* is required to obtain the client’s approval prior to adding a project or projects to an *Investment Fund*.

#### **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.