THE ABCs OF ADRs
INVESTING IN FOREIGN STOCKS

Americans just love to buy foreign—Japanese cars, Swiss watches, Russian caviar, Swedish vodka, Saudi oil, Colombian coffee, New Zealand lamb, French perfumes, Italian fashions, computer components from Singapore, and lots of good things from China.

And when it comes to investing, America's appetite for foreign equities has also been growing. By the end of this year's first quarter, U.S. investment in non-U.S. equities totaled $3.27 trillion—up from just $19 billion in 1980. Although foreign shares now account for 17.1 percent of total U.S. equity investment, many leading investment advisors recommend still greater international diversification of U.S. stock portfolios.

Aiko Young, Equity Market Strategist at Standard & Poor's, for example, recommends that 30 percent of American equity portfolios should be in non-U.S. stocks. S&P says four-fifths of this should be in developed markets like Europe, Japan, and Canada, with the remaining one-fifth in emerging markets like Russia, India, China, Mexico, and Brazil.

WHY DIVERSE?
One good reason for Americans to increase their holdings of foreign equities is risk reduction. Just like holding a variety of stocks in different industries reduces volatility and risk in domestic-only equity portfolios, diversification across countries and regions provides investors with similar protection. A sell-off in one market prompted by bad news, local politics, or business cycle developments will often be mitigated or offset by stronger performance elsewhere, smoothing out the ups and downs in the value of a geographically diverse portfolio.

In fact, American investors who invest only in U.S. equities are pursuing a riskier long-term strategy. Not only are they missing opportunities in more than half

**ADRs vs. U.S. STOCKS Relative Performance**

ADRs have outperformed U.S. Equities in recent years but have had greater price volatility

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the world, measured by recent stock market capitalization, but when the U.S. cycle shifts into reverse, Americans who do not own foreign shares won’t benefit from the better performance likely in at least some national stock markets around the world.

Cyclical prospects for the major industrial economies suggest now is a particularly good time for Americans to step up their non-U.S. equity holdings. The United States economy is late in its cyclical expansion phase when growth in personal incomes, output, and profits usually slow and aging bull markets begin to falter. In contrast, Japan’s business cycle is peaking and its young stock market is still growing.

in corporate earnings typically support rising equity prices. And, Europe is somewhere in between, showing resilience in personal incomes, corporate profits, and investor optimism. Apart from cyclical developments, European equities should continue to benefit from a wave of cross-border restructuring and the merging of national markets for European goods and services.

There are other good reasons for American investors to look abroad. S&P portfolio strategist Alex Young puts prospective dollar depreciation at the top of the list as narrowing interest rate differentials with Europe and Japan favor the yen and the euro. “So far this year most of the world’s stock markets have been remarkably flat,” but Young points out that “international equity markets still outperformed the U.S. averages because of a declining dollar,” a trend that many expect will continue for the next few years.

The various developments we’ve come to call “globalization” also suggest that now is the time for American investors to step up their exposure to foreign equities. Stock markets in many of the emerging market economies of Asia and Latin America are potentially the biggest beneficiaries. We are already seeing the supply-side effects of globalization in these countries – a rise of consumerism, increasing demand for health and financial services, major infrastructure development (roads, rail and subway systems, ports, airports, power generation, etc.), and the rise of world-class corporations that can compete effectively against leading American, Japanese, and European companies.

Importantly, these emerging market economies are so much smaller than the United States. At the same time, they are still early in their economic maturation and industrialization process. These two factors suggest that their stock markets – despite their inherent short-term price risk – may register relatively attractive growth over the longer term.

HAVE I GOT A TIP FOR YOU?! Now that you’ve read this far and are considering the world of international equities there are some important things you need to know.

To begin with, buying (or selling) shares of foreign companies directly on their home-country stock markets is not only cumbersome but it is generally more expensive. Americans will pay additional commissions not only to a foreign stockbroker but to a currency dealer, as well, to convert dollars into euros, rubles, yen, pounds, euros, etc., and for dividends-paying stocks will suffer recurring currency exchange fees again on the way out – and, since any dividends will be paid in local currency, investors holding dividend-paying stocks will suffer recurring currency exchange fees again. What’s more, U.S. investors may be subject to local tax withholding on dividends and capital gains.

To avoid the hassle and expense of investing directly in foreign stocks, there are a multitude of
mutual funds, exchange-traded closed-end funds, and exchange-traded index funds (ETFs) that offer U.S. investors easy access to foreign stocks. Some funds span the globe – holding what they consider to be the best stocks from a variety of countries and regions. Others invest in one particular country or region, or specialize in emerging markets or other selection criteria.

For many individual investors, selecting a diversified basket of foreign stocks – either an exchange-traded index fund or a mutual fund with a good track record from one of the major mutual fund management companies like Fidelity or Vanguard – is a safe way to benefit from foreign equity exposure.

There is a third way for U.S. investors to buy, hold, and sell foreign stocks – one that avoids dealing with overseas brokers and currency dealers yet offers access to individual companies for those who want to do their own international stock selection. American Depository Receipts – or, simply, ADRs – make investing in foreign stocks just as easy as buying shares in Microsoft, Wal-Mart, or any other American company.

WHAT EXACTLY ARE ADRs?
American Depository Receipts are negotiable certificates issued by a depository institution like JPMorgan Chase representing ownership of securities of non-U.S. companies held outside the United States on behalf of

U.S. INVESTMENT IN FOREIGN EQUITIES (ADR and local shares)
U.S. investment in foreign equities has risen from $19 billion in 1980 to $3.3 trillion in March 2006.
THE ABCs OF ADRs
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U.S. investors. The first ADR was created in 1927 by J.P. Morgan as a vehicle for U.S. institutional investors to indirectly own shares of Selfridges, the British retail chain, despite U.K. restrictions prohibiting the actual securities from leaving the country.

Today, some 1,812 foreign companies from over 80 countries have depository receipt programs — and there are currently 462 ADRs listed on national stock exchanges, mostly on the NYSE, which has 328 listed ADRs. Another 940 ADRs trade in the over-the-counter (OTC) market. Despite their foreign accent, many ADRs have long been household names familiar to U.S. investors, companies like Cadbury Schweppes, Honda, Sony, and Novartis.

ADRs certify that the underlying shares of a non-U.S. company have been deposited with the depositary's custodian in the company's home country. ADRs most often represent an equivalent number of shares — but occasionally the ratio of ADRs to underlying shares may differ. So, for example, one ADR might represent a fraction of the underlying share and another might represent 2 or 3 shares of the issuing company. Although ADRs are, in fact, issued by a depositary institution, the foreign companies whose shares they represent and which, in most cases “sponsor” their issuance, are often referred to as the “issuers.”

Importantly, ADRs are U.S. securities and, as such, they are new equity capital in the United States and may be exchange listed.

SEC Rule 144A ADRs are issued on behalf of non-U.S. companies wishing to raise equity capital in the United States through the private placement of depository receipts with large U.S. institutional investors. Rule 144 ADRs do not require registration with the Securities and Exchange Commission.

SEC Regulation S DRs — also known as Global Depositary Receipts or GDRs — are used to raise equity capital outside the United States. They do not require SEC registration and are not subject to U.S. regulatory supervision. However, U.S. investors may not purchase Reg S DRs. Global Depositary Receipts are traded outside the United States, principally in London and Luxembourg, and are subject to the rules of the exchanges where they are listed or traded.

“Unsponsored” ADRs are sometimes issued by depositary institutions in response to U.S. Investor demand for a foreign stock. These are issued without a formal agreement with the foreign company whose shares they represent — that is, without their sponsorship.

THE ABCs OF DEPOSITORY RECEIPTS
Not all depository receipts are created equal. Here’s a brief overview of DR terminology.

The majority of DRs are “Sponsored” — that is, they are issued by a depository on behalf of a non-U.S. client corporation wishing to establish a presence in the United States, often to broaden its shareholder base, improve its share valuation, raise equity capital in this country, or achieve other strategic objectives.

Level I ADRs are the easiest, least costly way for non-U.S. companies to establish a presence in the U.S. They do not require full compliance with SEC reporting requirements and are exempt from Sarbanes-Oxley financial disclosure. However, these ADRs may not be listed on a national stock exchange or used for raising new equity capital. They can, however, trade in the U.S. over-the-counter market.

Level II ADRs must comply fully with SEC registration and reporting requirements as well as Sarbanes-Oxley’s more stringent disclosure — and they may be listed on any of the three national stock exchanges. Issuers usually do not use a Level II ADR to raise capital.

Level III ADRs require still more stringent and costly financial disclosure. They are typically issued to raise new equity capital in the United States and may be exchange listed.

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regulated by the Securities and Exchange Commission. They are denominated in U.S. dollars – and like other U.S. securities – they trade in dollars. ADR owners also receive dividends in dollars and corporate communications are in English. ADRs are bought, sold, and clear just like any U.S. equity – and transactions costs are also similar. As U.S. securities, they can be held by U.S. institutional investors, such as pension plans, which otherwise may be prohibited by their own charters from owning non-U.S. securities.

Depositary institutions, like JP Morgan, provide a variety of services that are important not only to the foreign companies, on whose behalf they issue ADRs, but also to the retail and institutional investors who buy, hold, and sell ADRs. Importantly, it is their function to create and cancel ADRs on behalf of investors so that the supply and demand for ADRs in the U.S. market remains in equilibrium with the supply and demand for the underlying shares in the home market. This assures that prices in both markets are always comparable, allowing for transactions costs at the current exchange rate.

So, for example, if the price of an ADR on the New York Stock Exchange rises above the price of the underlying security in the home country market (at the current exchange rate and allowing for transactions cost) investors will likely buy shares locally, place the certificates with a custodial agent in the home country, and have the depositary bank issue new ADRs, increasing the supply available in the U.S. market.

JP Morgan’s James Keane points out that an ADR is “a mechanism that needs to be executed – creating and cancelling ADRs to maintain price equilibrium between the U.S. and home market, handling corporate actions, managing shareholder accounts, transferring ADRs between buyers and sellers, communicating with shareholders, converting foreign currency dividends and paying U.S. shareholders.” It is these “behind-the-scenes” activities that make U.S. investment in foreign equities through the mechanism of American Depositary Receipts virtually indistinguishable from investment in the shares of any American company.

ADR FOR THE RETAIL INVESTOR

Ease of Use – ADRs are quoted in U.S. dollars, trade just like U.S. equities, and settle through a U.S. depository just like a U.S. security.

No-Hassle Dividends – ADR investors receive their dividend checks promptly and in U.S. dollars.

Access – ADRs offer U.S. investors easy, low-cost access to some of the world’s best equity investment opportunities.

Do-it-yourself International Diversification – Unlike mutual funds and ETFs, ADRs give U.S. investors who want global diversification the opportunity to select exactly the foreign companies they like.

English Spoken Here – Corporate communications, including shareholder reports, financial statements, and corporate actions are translated into English for ADR holders. Plus, current trading data is readily available.

Transparency – Issuers of exchange-traded ADRs are required to maintain the same financial reporting standards as U.S. companies with comparable exchange listings.

Lower transactions costs – Brokerage commissions on ADRs are similar to commissions on other U.S. equities. And international investing through ADRs avoids foreign brokerage and currency exchange commissions.

Lower custody fees – Foreign custody fees range from 10 basis points per year on the value of the investment in developed markets to more than 35 basis points per year in emerging markets. By contrast, custody fees on ADRs – as with U.S. equities – are often no more than $35 and are not based on the value of the securities.

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Q: Why do foreign companies issue ADRs?

JK: Non-U.S. companies often issue ADRs to raise new equity capital in the United States. Sometimes a foreign company will launch an ADR program to create an "acquisition currency" to support prospective corporate acquisitions in the United States. And almost always, non-U.S. issuers of ADRs are pursuing other strategic objectives that potentially can have a positive effect on their company's market valuation.

Companies can also choose to list in either London or Luxembourg via a Global Depositary Receipt or GDR. In recent years, capital raising using GDRs has steadily increased.

Q: What strategic objectives might be achieved with an ADR program?

JK: A well-executed ADR program raises an issuer's visibility in the U.S. investment community, creates new demand for its shares and ultimately diversifies the company's shareholder base. Geographic diversification can reduce price volatility because selling in one region may be mitigated by demand in another.

Launching an ADR program makes sense for many companies that already have significant business interests in the U.S. — where a well-known brand name can be associated with its stock. For a consumer-oriented company with a presence in the U.S., greater visibility arising from its ADR program can be very positive for its commercial business. Companies with a strong brand image may attract consumers to become investors and investors also often become new customers.

Q: Is now a good time for non-U.S. companies to launch ADR programs?

JK: For a company that plans to raise new equity capital, enjoy brand-name recognition among U.S. consumers, and is willing to bear the cost of adopting U.S. GAAP (United States Generally Accepted Accounting Principles), timing is very important. You want to take advantage of windows of opportunity when stock valuations are strong.

However, I would argue that timing is almost irrelevant for companies coming to the U.S. for reasons other than raising new capital. It's a long-term strategic decision. Raising visibility, diversifying the shareholder base, improving your market valuation — this is a multi-year effort. It may be easier to get started in a strong market when investor interest is high. However, if the issuer is not raising capital, it doesn't have to worry about selling itself short in a weak market.

Q: What about the cost to the issuing company of coming to the U.S. with an ADR program versus listing in their home stock markets?

JK: This is a relevant consideration. It can be costly for some companies to ensure that their financial accounts are in compliance with U.S. accounting standards and Sarbanes-Oxley regulations. The diversion of senior management time may be a significant intangible. And, a U.S. investor relations effort can have a sizable price tag.

However, for well-governed companies, greater disclosure and transparency promote investor confidence, improve credit ratings, and represent a "seal of approval" that, at the end of the day, can translate into premium valuations and lower borrowing costs.

Q: What role does investor relations play in a successful ADR program?

JK: A commitment to investor relations with resources devoted to the U.S. is essential for new as well as established issuers. More and more foreign issuers are recognizing that the success of their ADR programs — measured by a growing investor base and a healthy market valuation — requires a full-time U.S. investor relations effort.

Issuers with 20% or 30% of their shareholder capital in ADRs will want a full-time investor relations officer, if not a team, based in the U.S. to look after existing investors and market to new investors.

In addition, senior executives must take the time to visit institutional investors and securities analysts at least twice a year, if not more. Consumer products companies with recognized brands should also consider visits to retail stockbrokers in every region and attend the major retail investor conferences to develop support among individual investors.