Perspectives on American Depository Receipts (ADRs)

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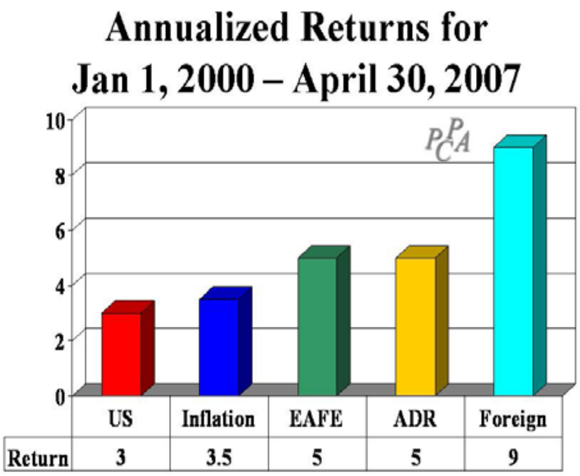
U.S. stock markets have not kept pace with inflation thus far in the 21st Century, having earned 3% per year for the 7.3 years ending 4/30/07, while inflation has averaged 3.5%.



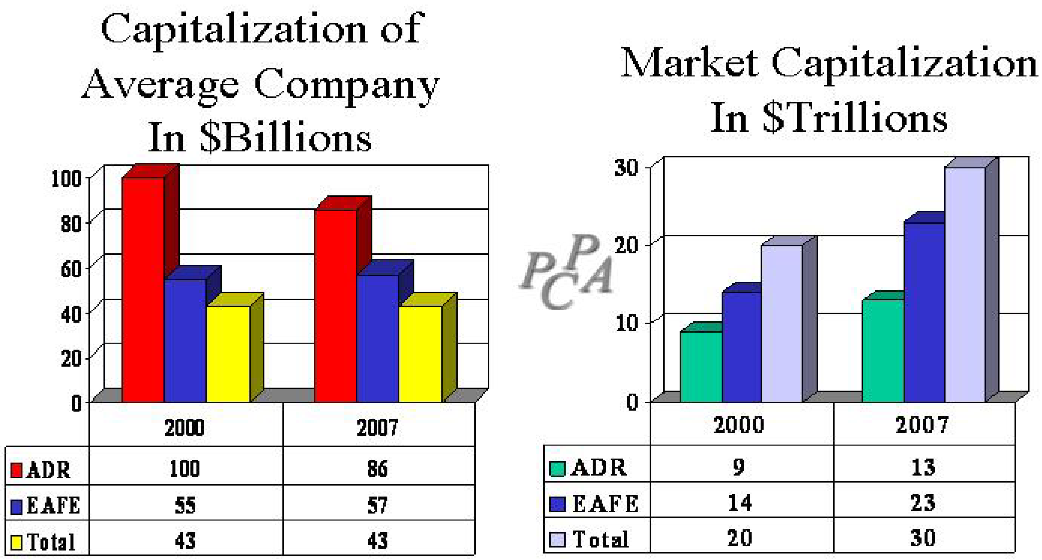
At the same time, non-U.S., or foreign, markets have performed quite well, earning 9% per year, or 3 times the return on U.S. stocks. American Depository Receipts (ADRs) have also outperformed the U.S. stock market although they have not fared as well as the total foreign market, earning 5% per year, which is almost double the U.S return. These advantages have not gone unnoticed. U.S. investors have intensified their interest in investing outside the U.S.

Investors who make the leap abroad will have a choice between active and passive management. If they choose active management, they'll also have an additional choice between managers who hold the ordinary shares of foreign companies and those who hold portfolios of American Depository Receipts, or ADRs, traded on U.S. exchanges. ADRs are offered on a wide variety of large foreign companies, and afford reasonable participation in foreign market returns with much more efficient trading, settlement and custody. As always, these choices should be guided by the investor's assessment of manager skill – will I be rewarded for active management fees? The following perspectives should help.

Characteristics of ADRs

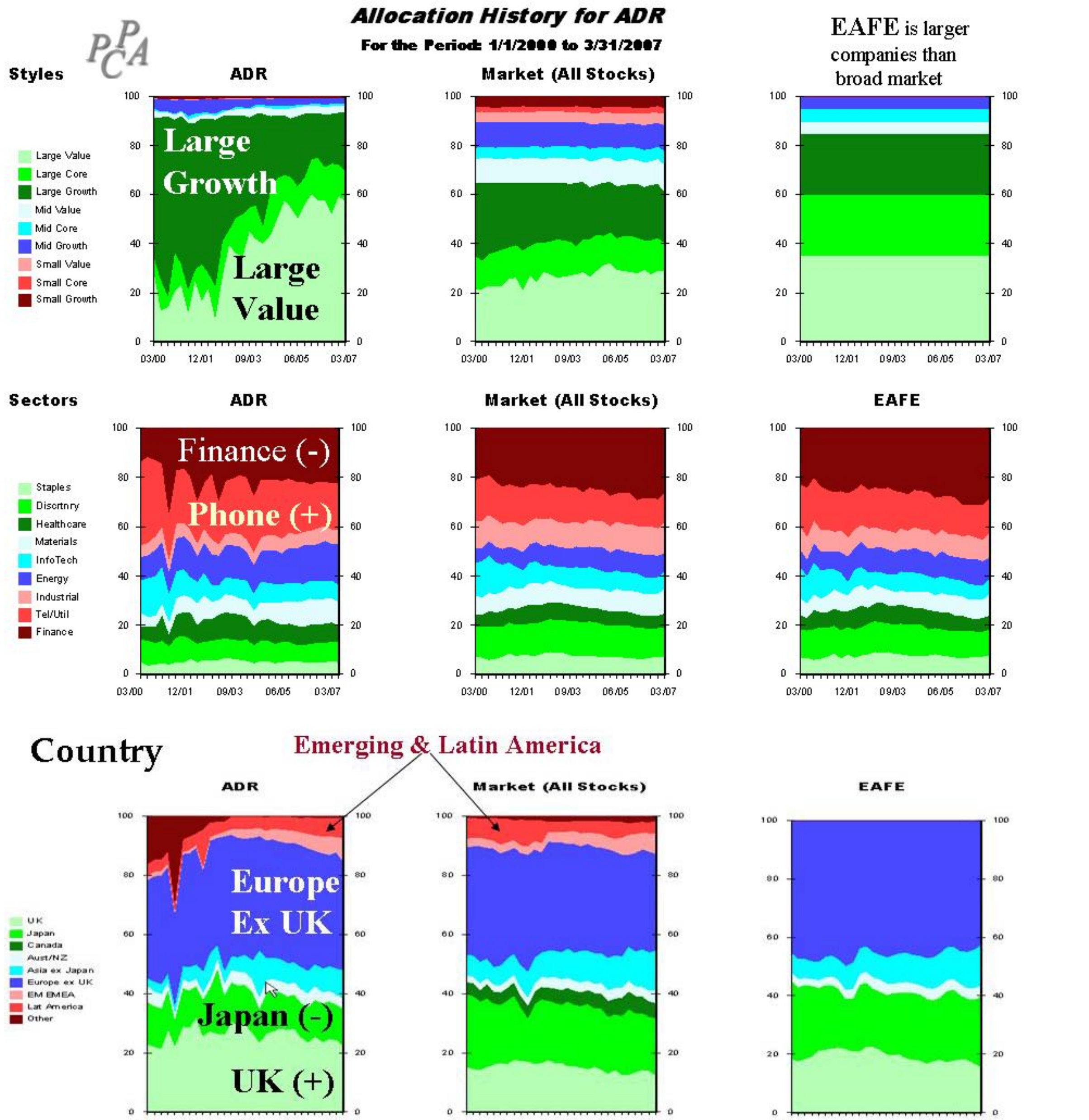
In order to set reasonable performance expectations it's helpful to know the make-up of the ADR market. These investments are available for the very largest companies around the world, and their collective style and country profile is a reflection of where these large companies reside. Exhibit 1 contrasts the size of the average ADR company to that of the average stock in the EAFE (Europe Australia Far East) index and the entire foreign market. As you can see, the average ADR company is about twice the capitalization of the average foreign stock at large. Also shown is the breadth of the ADR market, measured as total capitalization. The collection of stocks with ADRs represents about 45% of the total market. In other words, ADRs provide exposure to the world's mega firms although collectively these represent less than half of the total market.

<u>Exhibit 1: Company and Market Size</u>



These mega ADR firms were primarily growth stocks at the beginning of the Century, but the bursting of the growth bubble has morphed them into mega value firms. On the sector front, ADRs have been consistently more allocated to phones than the broad market and EAFE, and underweighted in finance companies. Geographically, ADRs have market-like exposures to emerging markets and Latin America, which are excluded from EAFE. They are also underweight in Japan and overweight in the UK. We use Surz indexes, described at [Style Indexes](), throughout this commentary.

Exhibit 2: Style, Sector and Country Profiles Compared to the Total Foreign Market and EAFE



We can also see the changes in make-up through time by contrasting the largest ADRs at the start of the Century to the current largest ADRs, as provided in the following table:

Largest 10 ADRs today and at the start of the Century

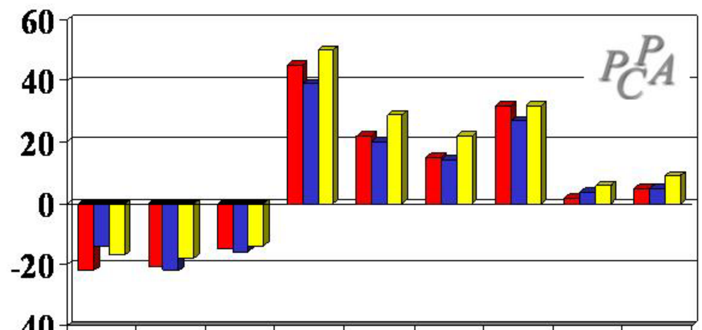
2007	%		Style	Sector	Region
		GAZPROM			EM
	2.59	Russia	LrgeGro	Energy	EMEA
	2.46	PETROCHINA	LrgeVal	Energy	ASIAexJ
	2.26	**ROYAL DUTCH**	LrgeVal	Energy	UK
	2.15	**BP PLC**	LrgeVal	Energy	UK
	2.11	**TOYOTA**	LrgeCor	Dsctnry	Japan
	2.05	HSBC HLDGS	LrgeVal	Finance	UK
	1.68	CHINA MOBIL	LrgeGro	Tel&Utl	ASIAexJ
	1.6	TOTAL SA	LrgeVal	Energy	EURexUK
	1.45	GLAXO	LrgeVal	HlthCar	UK
	1.43	**VODAFONE**	LrgeGro	Tel&Utl	UK
	19.76				
2000					
	4.27	**VODAFONE**	LrgeGro	Tel&Utl	UK
	3.95	TELSTRA	LrgeCor	Tel&Utl	Aust&NZ
	3.85	NIPPON TELE	LrgeGro	Tel&Utl	Japan
	3.13	NOKIA	LrgeGro	InfoTek	EURexUK
	3.03	DTSCH TLKOM	LrgeGro	Tel&Utl	EURexUK
	2.71	**BP AMOCO**	LrgeVal	Energy	UK
	2.57	**TOYOTA**	LrgeGro	Dsctnry	Japan
	2.18	BR TELECOMM	LrgeGro	Tel&Utl	UK
	1.93	FRANCE TEL	LrgeGro	Tel&Utl	EURexUK
	1.83	**ROYAL DUTCH**	LrgeVal	Energy	EURexUK
	29.43				

As you can see, the 10 largest companies currently represent about 20% of the total ADR market, and are predominantly large value energy companies. By contrast, at the beginning of the Century the top 10 represented 30% of the ADR market and these ADRs were predominantly large growth phone companies. The 4 stocks emboldened in the table have remained in the top 10. These analyses cover about 550 companies with ADRs.

Performance in the 21st Century

ADRs have performed in line with the EAFE index in this Century, but have lagged the broad foreign market. This Century's foreign market winners have generally been smaller companies. If we extend our horizon back 10 years, to include the growth bubble, ADRs have outperformed EAFE, and matched broad market performance. The following graph summarizes annual and cumulative performance in the Century.

Exhibit 3: Year by year, and Century-to-Date Returns



2000:	0	1	2	3	4	5	6	Q1	all
ADR	-22	-21	-15	45	22	15	32	2	5
EAFE	-14	-22	-16	39	20	14	27	4	5
Total	-17	-18	-14	50	29	22	32	6	9

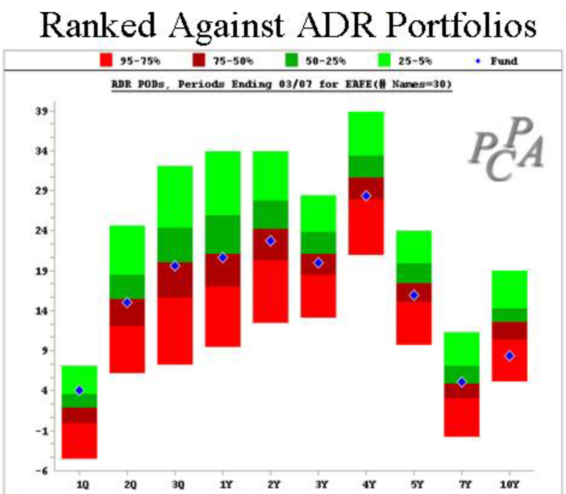
With the exceptions of the year 2000 and the 1st quarter of 2007, ADRs have outperformed EAFE, although they have generally lagged the broad foreign market.

Investors have 2 questions to answer in considering an ADR manager:

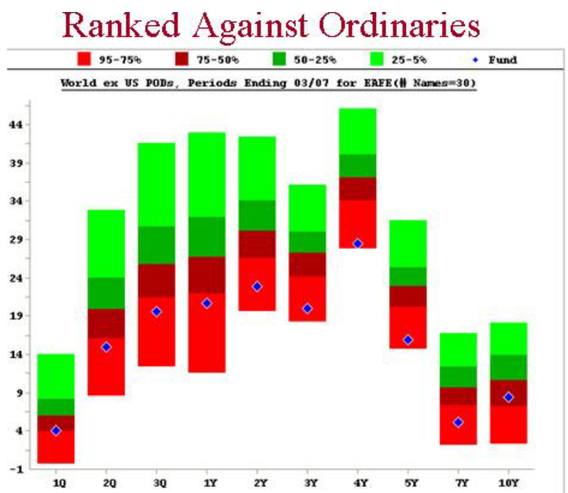
1. Do we like the idea of using ADRs, for their trading efficiencies and exposure, and
2. Does this manager do a good job of selecting ADRs?

The 2nd question can be best answered by contrasting the manager's performance to the opportunities available to ADR managers. But there are no suitable peer groups to make this comparison, and even if there were we would be concerned about the biases that are inherent in all peer groups. So we create instead all of the possible portfolios that could have been constructed from ADRs through time using portfolio simulations. This technology is called "Portfolio Opportunity Distributions" or PODs, and is described at PODS. The following universes on the left will help you evaluate your ADR manager – just rank the manager's performance against the ADR opportunity set. The universes on the right provide the same ranking capability using the entire stock market of ordinary foreign companies as the opportunity set, so you can also evaluate a manager who is not using ADRs. For illustrative purposes we have ranked the EAFE index in this fashion. As you can see, the index has performed near the ADR population median for the past 7 years, but well below median for 10 years. By contrast EAFE has not performed well in a total market context, primarily because it is void of the better performing regions of the world like emerging markets, Latin America and Canada, and it is overweight in the worst performing country, Japan.

Exhibit 4: EAFE Index Rankings



	1Q	2Q	3Q	1Y	2Y	3Y	4Y	5Y	7Y	10Y
Fund	4.1	15.0	19.6	20.7	22.8	20.0	28.4	15.9	5.1	8.4
5%	7.1	24.6	32.0	33.9	33.9	28.4	38.8	23.9	11.2	19.0
25%	3.6	18.5	24.3	25.9	27.7	23.8	33.4	19.9	7.1	14.3
50%	1.8	15.4	20.0	21.1	24.2	21.1	30.6	17.4	4.9	12.5
75%	-.1	12.0	15.6	17.0	20.3	18.4	27.9	15.0	3.0	10.3
95%	-4.6	6.1	7.2	9.4	12.4	13.1	20.9	9.7	-1.8	5.1

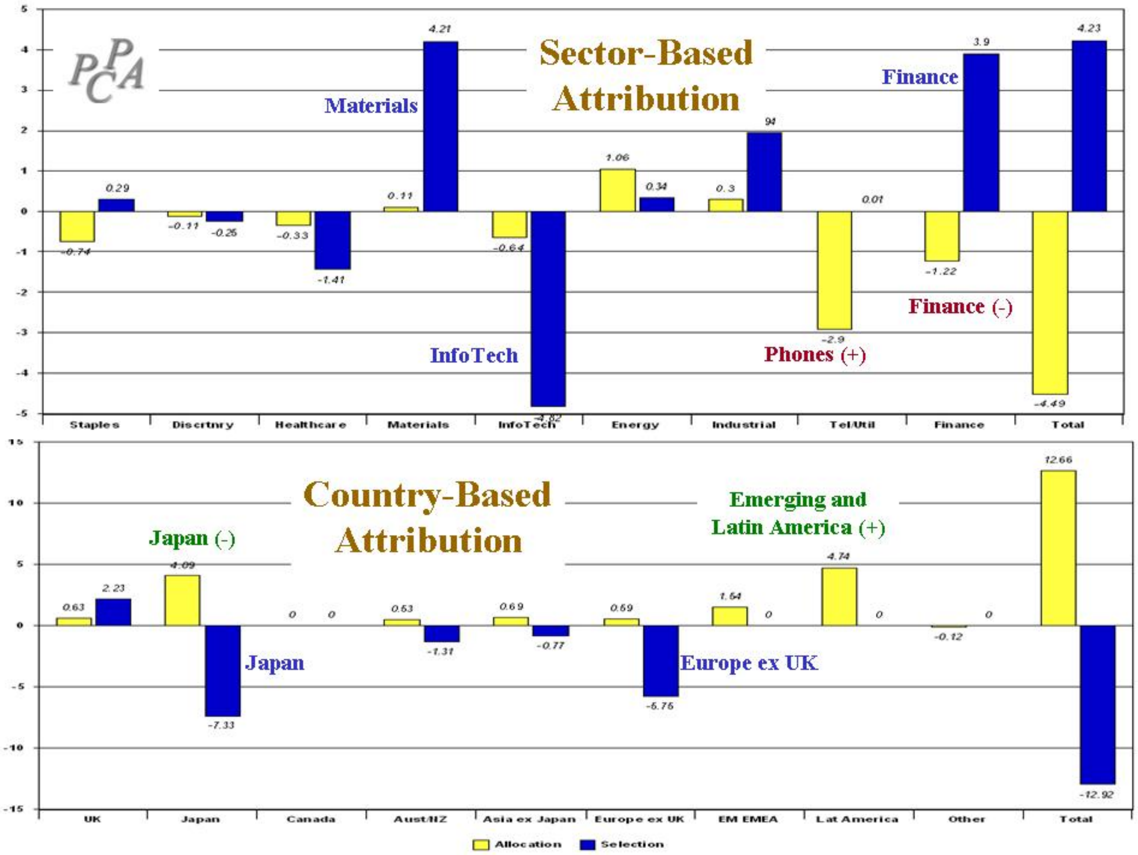


	1Q	2Q	3Q	1Y	2Y	3Y	4Y	5Y	7Y	10Y
	4.1	15.0	19.6	20.7	22.8	20.0	28.4	15.9	5.1	8.4
	14.0	32.8	41.5	42.9	42.4	36.1	46.0	31.4	16.7	18.1
	8.2	23.9	30.6	31.8	34.0	30.0	40.0	25.3	12.3	13.9
	6.0	19.9	25.7	26.7	30.1	27.2	37.0	22.8	9.7	10.6
	3.9	16.1	21.3	21.9	26.5	24.1	34.0	20.1	7.3	7.2
	-.3	8.5	12.3	11.5	19.6	18.2	27.8	14.7	2.1	2.3

Attribution

Why have ADRs performed in line with EAFE? This is an important question because we'd like to make a judgment about the trade-offs between these 2 choices. The following exhibit uses StokTrib (click Attribution) to show that sector allocation hurt ADR performance, but this was offset by strong performance in materials and finance companies. Specifically, the overweight in phone companies and underweight in finance hurt performance. Of course an active ADR manager is not required to hold EAFE weights. On a country basis, exposure to emerging markets and Latin America benefited performance, as did an underweight to Japan relative to the EAFE index. However ADR stocks in Japan and Europe ex UK underperformed their EAFE counterparts, reflecting the lagging performance of mega firms in these regions.

Exhibit 5: Attribution Analyses (Allocation in Yellow & Selection in Blue)



Conclusion

Exposure to foreign markets has been a good thing for U.S. investors so far in this Century, and it turns out that either EAFE or ADRs would have been about as good, but the best 21st Century choice has been much broader, encompassing smaller companies and non-EAFE regions. Looking forward, diversification into foreign markets should help stabilize performance, even if the U.S. regains the lead. Once the decision is made to diversify abroad, this article can help in choosing between active and passive, and between ADRs or ordinaries. Please keep it as a reference for establishing expectations and for understanding future performance.

Also please visit our white paper at Accurate Benchmarking for our thoughts on identifying managers with skill. If we're going to take the time and energy to select an active manager we should pick the best we can.