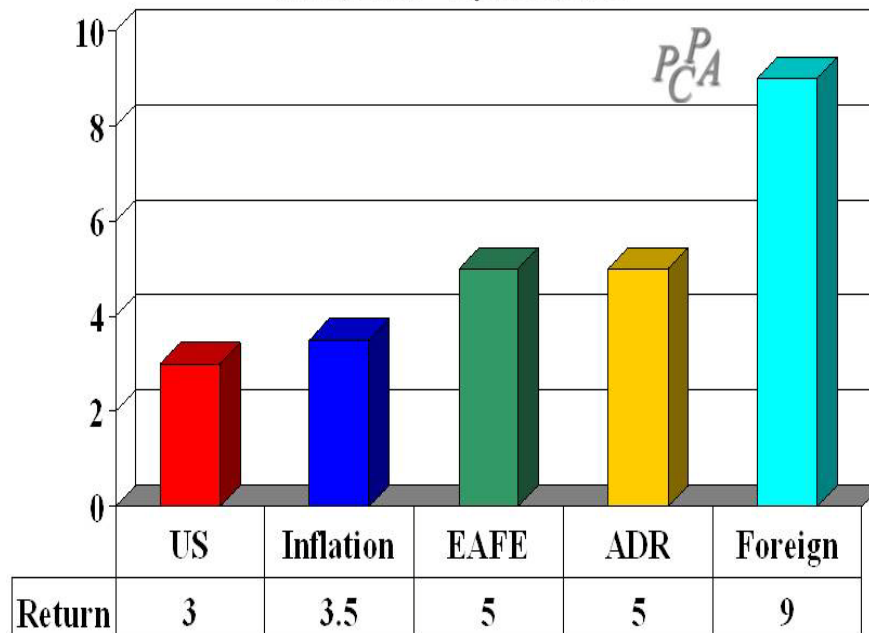


# Update on Perspectives on American Depositary Receipts (ADRs)

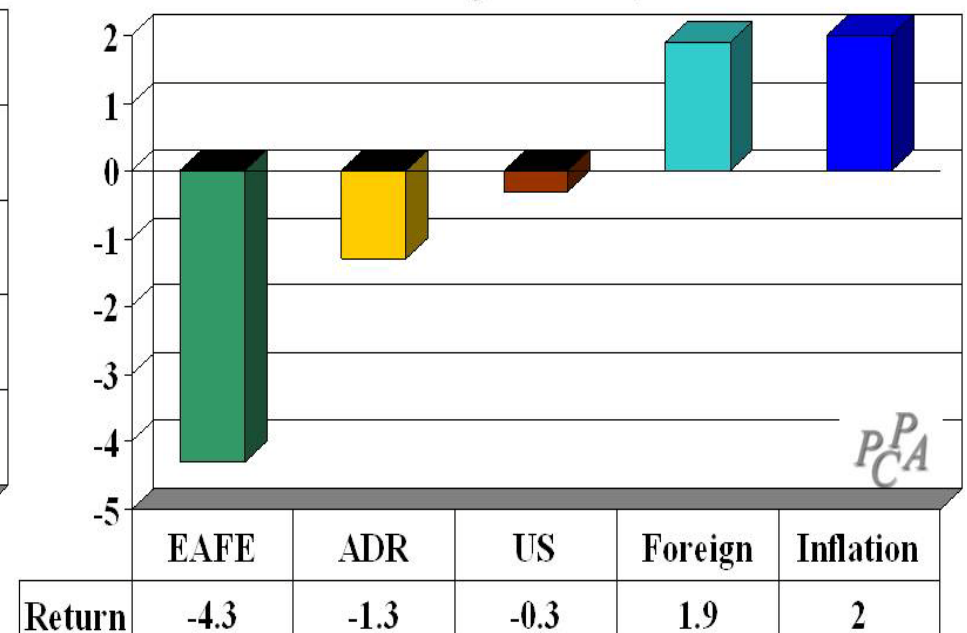
Ron Surz PPCA 949/488-8339 [Ron@PPCA-Inc.com](mailto:Ron@PPCA-Inc.com) June, 2012

Five years ago I wrote [Perspectives on ADRs](#), describing the characteristics and performance of American Depositary Receipts for the century to date at that time, 1/1/200-4/30/2007. Now in this commentary I update the review through December, 2011, focusing on the last 5 years. For openers, the performance picture has changed dramatically as you can see in the following two exhibits.

**Exhibit 1: Annualized Returns from Original Study**  
Jan 1, 2000 – April 30, 2007



**Exhibit 2: Annualized Returns from Current Study**  
5 Years Ending December, 2011



Only the total foreign market has kept pace with inflation in the past five years, whereas the U.S. stock market was the only market that lagged inflation in the original study. As a result of the relative underperformance of the U.S. in the 1/1/2000-4/30/2007 period, investors intensified their interest in investing outside the U.S., and this time they had three choices rather than just two because exchange traded funds (ETFs) entered the scene in a big way.

Investors who make the leap abroad have a choice between active and passive management. If they choose active management, they have an additional choice from the following:

- Managers who hold the ordinary shares of foreign companies
- Those who hold portfolios of American Depositary Receipts, or ADRs, traded on U.S. exchanges
- Those who hold portfolios of exchange traded funds, or ETFs
- Combinations of the above, also known as “unrestricted”

ADRs are offered on a wide variety of large foreign companies, and afford reasonable participation in foreign market performance with much more efficient trading, settlement and custody. ETFs offer similar flexibilities and efficiencies. 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. I compare and contrast ADRs to EAFE and to the total foreign market. The perspectives are that EAFE is the most popular index for benchmarking non-US performance and it is also offered as an ETF. The total foreign market provides an unrestricted perspective, so you can see the effects of limiting investments to just ADRs or just EAFE stocks.

There are several ADR databases. The following discussion uses the Compustat database, which is the broadest alternative as shown in Table 1.

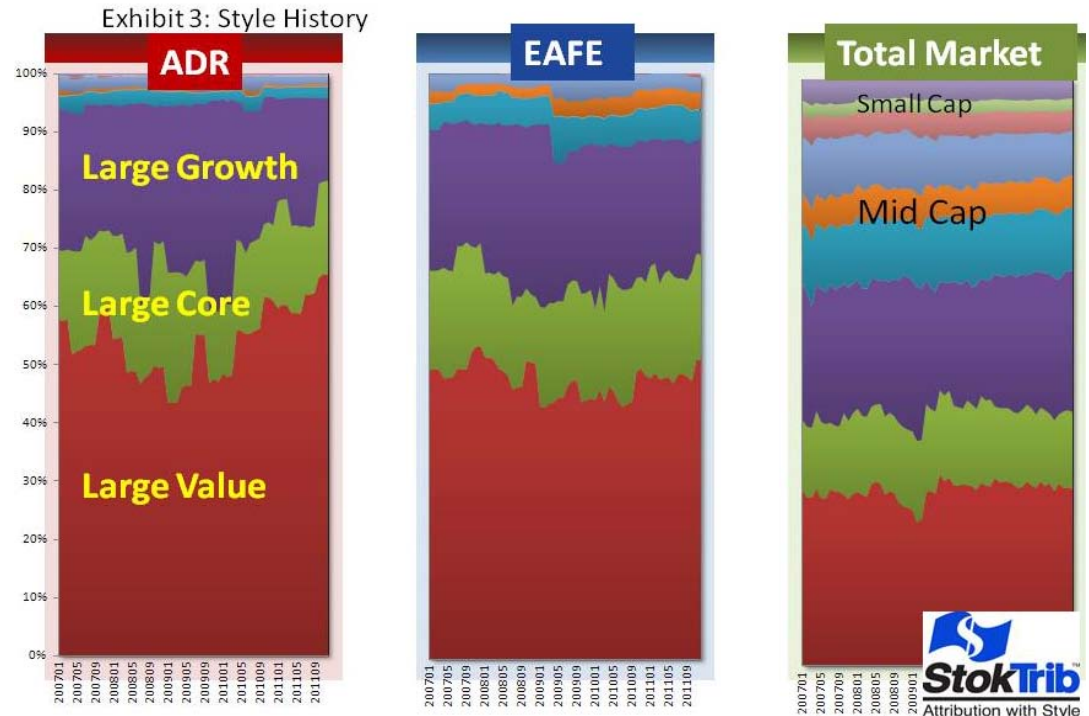
## Table 1: Index Composition Contrasts

	ADR Indexes				
	Surz/Compustat	S&P	Bank of NY	EAFE Index	S&P 500
# of Stocks	480	175	365	1150	500
\$ Trillions	\$9.3	\$5.4	\$6.1	\$9.6	\$13

Source: PPCA inc

## Characteristics of ADRs, EAFE and the Total Foreign Market

In order to set reasonable performance expectations it's important to know the style makeup of the ADR market. ADRs 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 are domiciled. Exhibit 3 contrasts the style makeup of the ADR market to that of the EAFE (Europe Australia Far East) index and the entire foreign market. As you can see, the ADR and EAFE markets are substantially larger companies than the broad foreign market, and are allocated much more to large cap value. The ADR market is even more allocated to large cap value than EAFE. We use Surz indexes, described at [Style Indexes](#), throughout this commentary.

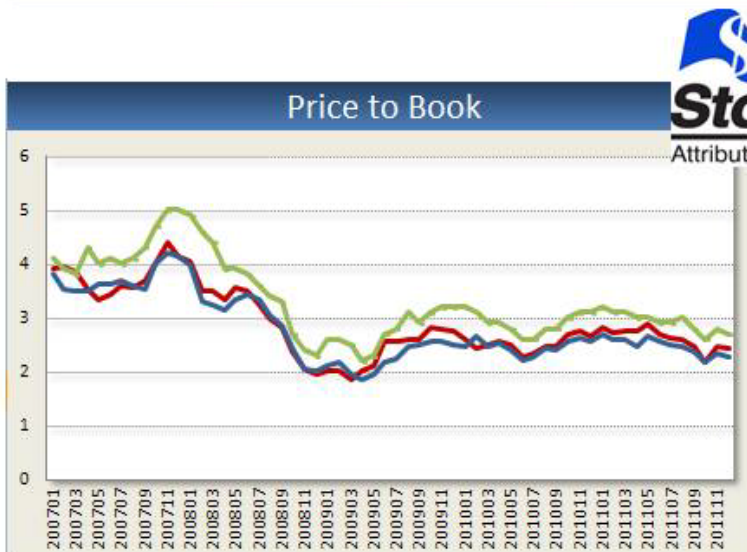
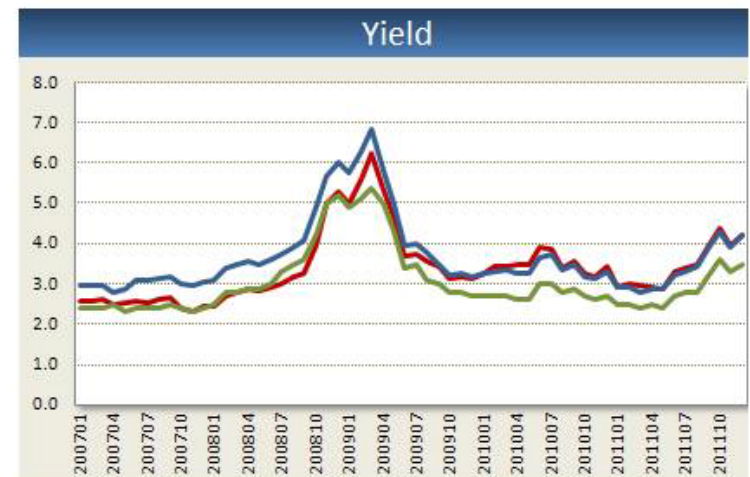
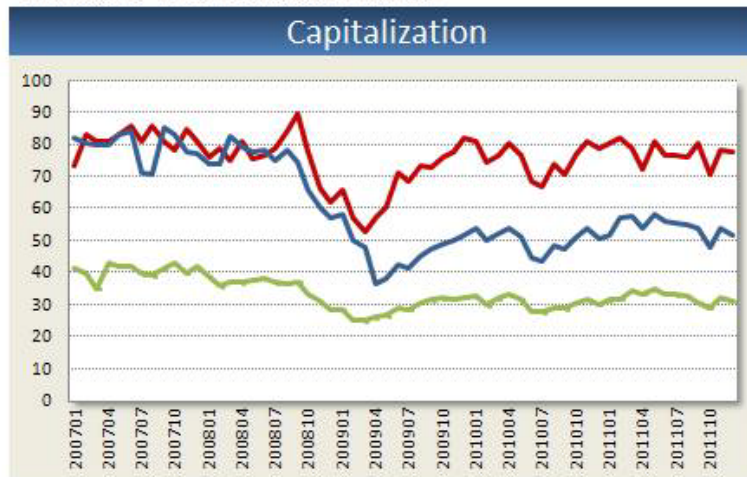


A closer look is provided by contrasting the characteristics of these three markets, as shown in Exhibit 4 below. Here are some observations:

- The capitalization of ADRs is larger than EAFE, especially in the last 3 years, and both are larger than the total market.
- The dividend yields of ADRs and EAFE are about the same, and both are higher than the total market, reflecting a value orientation.
- Price/book ratios of EAFE and ADRs are about the same, and are lower than the total market, again reflecting value. Ditto Price/earnings ratios.

Exhibit 4: Characteristics

-----ADR -----EAFE -----Total market



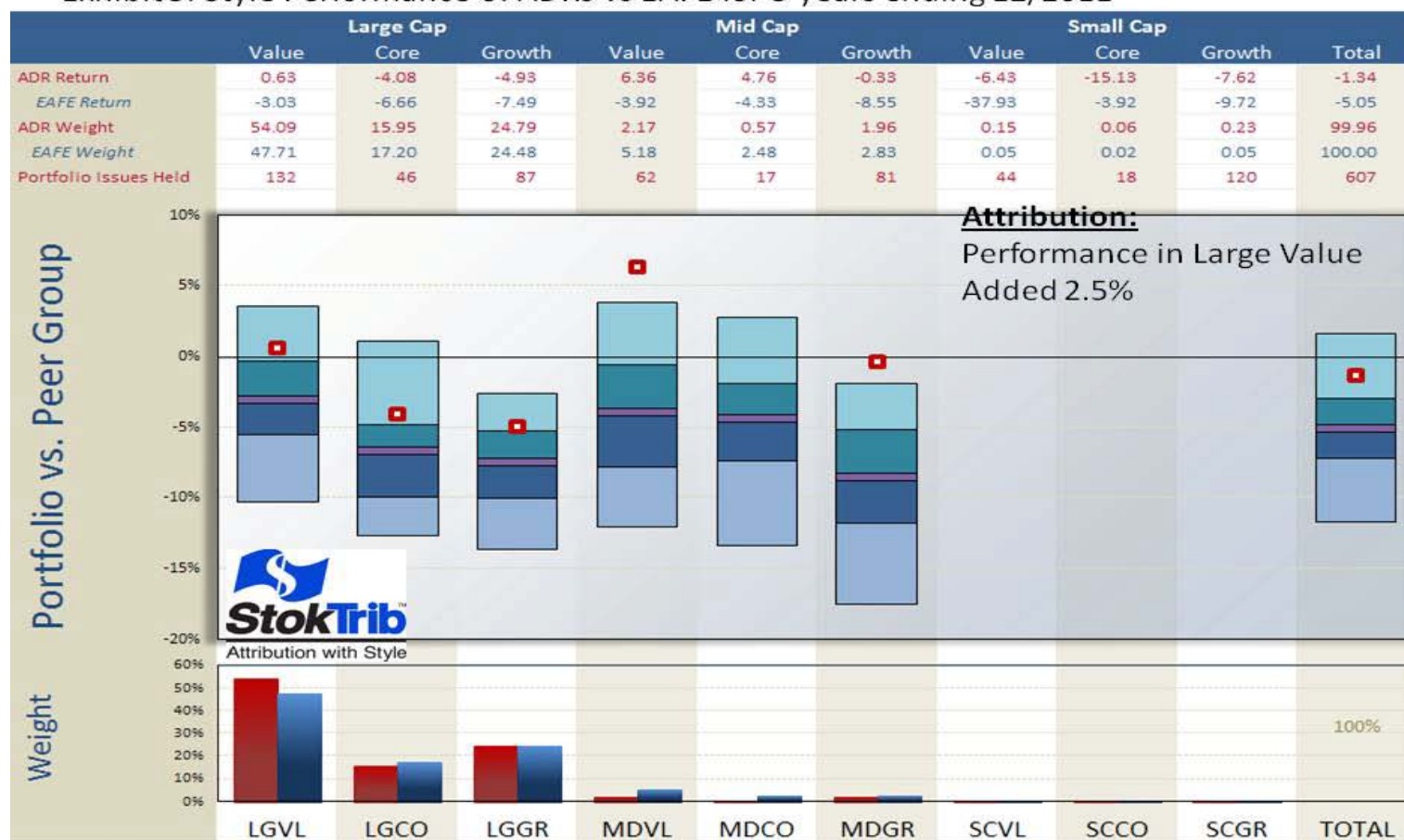
This sets the stage for the next section on recent performance.



## Performance of ADRs, EAFE and Total Foreign Market

ADRs have outperformed EAFE in the past five years but have underperformed the total foreign market. The primary reason is country allocation. In the following I show 5-year performance results of ADRs against EAFE. The universes shown employ [Portfolio Opportunity Distributions \(PODs\)](#). I attribute performance results using [StokTrib](#) to style, sector and country effects. Exhibit 5 shows performance broken out by style. Performance in large value won the day for ADRs.

Exhibit 5: Style Performance of ADRs vs EAFE for 5 years ending 12/2011



Next I look at performance broken out by country and find that performance in Europe-ex-UK and Latin America benefited ADRs, as shown in the bottom attribution panel. I further note that EAFE is void Latin America and Emerging Markets, while ADRs are not, so country allocation benefitted ADRs.

Exhibit 6: Country performance of ADRs versus EAFE for 5 years ending 12/2011



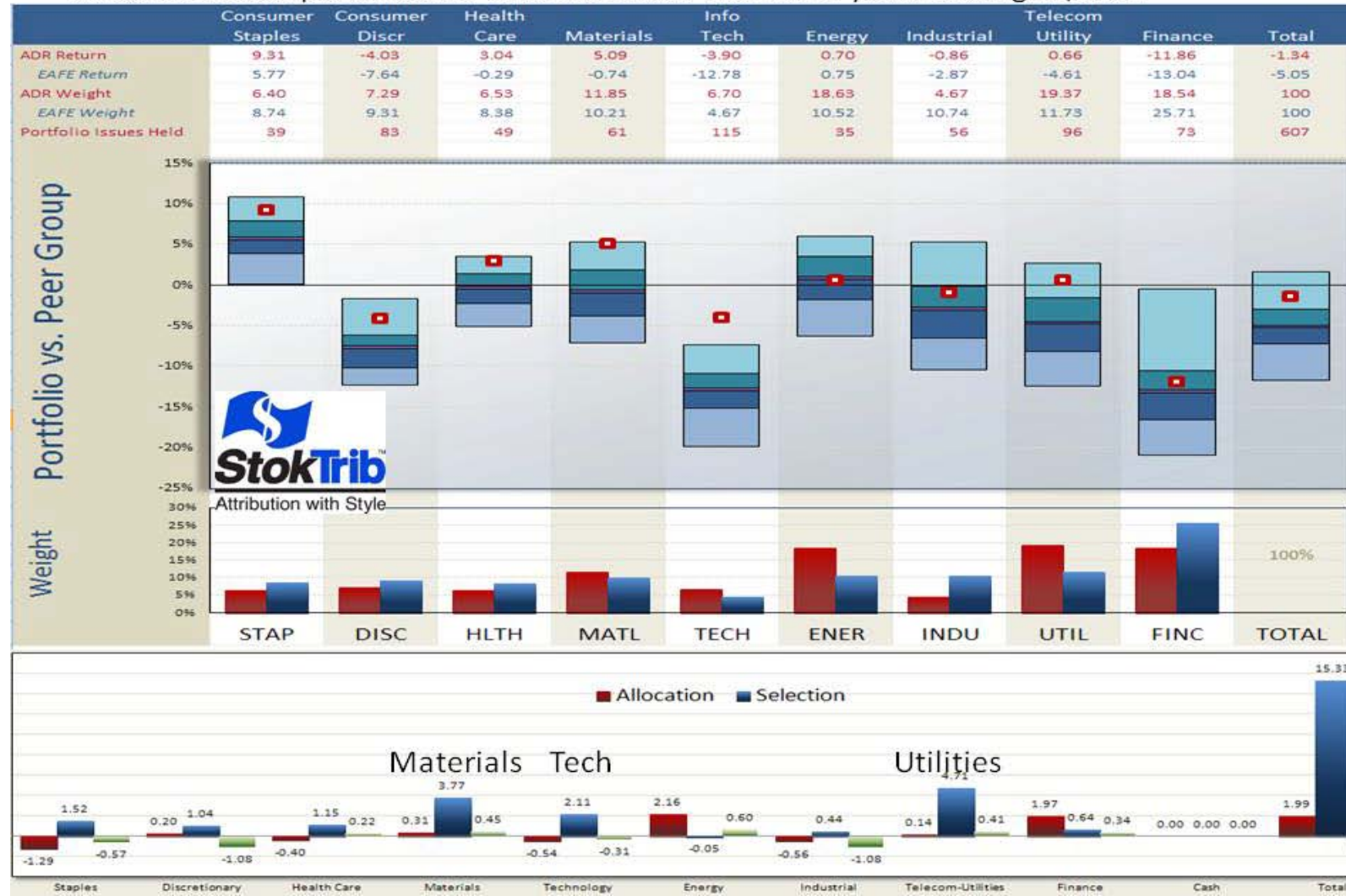
By contrast, stock selection rather than country allocation explains the performance differential between ADRs and the Total Market, as can be seen in Exhibit 7 which attributes ADR performance against the Total Foreign Market. As can be seen, ADR performance in several regions is bottom of the distribution, and the reason that ADRs have underperformed, subtracting 20% unannualized from performance relative to the total market.

Exhibit 7: Country performance of ADRs versus Total Foreign Market



Lastly, I looked at attribution based on economic sectors, as shown in Exhibit 8, where you can see that stock selection in three sectors won the day for ADRs vs EAFE: Materials, Technology and Utilities.

Exhibit 8: Sector performance of ADRs versus EAFE for 5 years ending 12/2011





The following table provides stock level insights. Note that most (6) of the largest holdings are Energy stocks.

Table 2: Biggest, Best & Worst ADR stocks in 5 years ending 12/2011

Description	Country	Sector	Style	Priods Held	Weight	Eff Retrn	Rpt Retrn	Impact
Largest Holdings								
PETROCHINA	China	Energy	Large Cap Value	60	2.48%	-12.93	11.21	-0.32
CHINA MOBIL	China	Telecom-Utilities	Large Cap Value	60	2.37%	10.56	42.32	0.25
ROYAL DUTCH	UK	Energy	Large Cap Growth	60	2.21%	32.68	56.70	0.72
BHP LTD	Australia	Materials	Large Cap Value	60	2.07%	52.96	107.66	1.10
PETRO BRASL	Brazil	Energy	Large Cap Value	60	1.98%	-39.02	18.82	-0.77
GAZPROM O A	Russia	Energy	Large Cap Value	60	1.87%	-73.15	-52.72	-1.37
BP PLC	UK	Energy	Large Cap Value	60	1.84%	-27.67	-11.11	-0.51
BHP BILLITN	UK	Materials	Large Cap Value	60	1.79%	43.41	90.56	0.78
HSBC HLDGS	UK	Finance	Large Cap Value	60	1.78%	-56.92	-40.20	-1.01
TOTAL SA	France	Energy	Large Cap Value	60	1.52%	-12.23	-1.52	-0.19
				60	19.91%	-1.32		
10 Largest Contributors								
COMP BEBIDA	Brazil	Consumer Staples	Large Cap Core	60	0.62%	233.54	161.42	1.44
BHP LTD	Australia	Materials	Large Cap Value	60	2.07%	52.96	107.66	1.10
BRITISH AME	UK	Consumer Staples	Large Cap Value	60	0.76%	110.13	127.67	0.84
BHP BILLITN	UK	Materials	Large Cap Value	60	1.79%	43.41	90.56	0.78
NOVO-NORDIS	Denmark	Health Care	Large Cap Growth	60	0.48%	152.02	182.97	0.74
ROYAL DUTCH	UK	Energy	Large Cap Growth	60	2.21%	32.68	56.70	0.72
BAIDU INC	China	Information Technology	Mid Cap Growth	60	0.21%	254.98	933.26	0.53
VODAFON-ADR	UK	Telecom-Utilities	Large Cap Value	60	1.48%	35.73	48.14	0.53
CNOOC LTD	China	Energy	Large Cap Value	60	0.75%	60.53	127.69	0.45
ECOPETROL	UK	Energy	Large Cap Value	36	0.45%	80.99	72.64	0.37
				58	10.82%	7.48		
10 Largest Detractors								
GAZPROM O A	Russia	Energy	Large Cap Value	60	1.87%	-73.15	-52.72	-1.37
HSBC HLDGS	UK	Finance	Large Cap Value	60	1.78%	-56.92	-40.20	-1.01
TOYOTA-ADR	Japan	Consumer Discretionary	Large Cap Growth	60	1.51%	-52.48	-46.88	-0.79
PETRO BRASL	Brazil	Energy	Large Cap Value	60	1.98%	-39.02	18.82	-0.77
MITSUBISHI	Japan	Finance	Large Cap Growth	60	0.86%	-73.41	-64.54	-0.63
ARCELORMITT	Luxemborg	Materials	Large Cap Value	60	0.64%	-80.31	-54.00	-0.52
BP PLC	UK	Energy	Large Cap Value	60	1.84%	-27.67	-11.11	-0.51
BNP PARIBAS	France	Finance	Large Cap Value	60	0.70%	-69.41	-52.06	-0.49
NOKIA ADR	Finland	Information Technology	Large Cap Value	60	0.71%	-65.95	-69.88	-0.47
BARCLAY PLC	UK	Finance	Large Cap Value	60	0.57%	-79.80	-75.18	-0.46
				60	12.46%	-7.02		



Attribution with Style



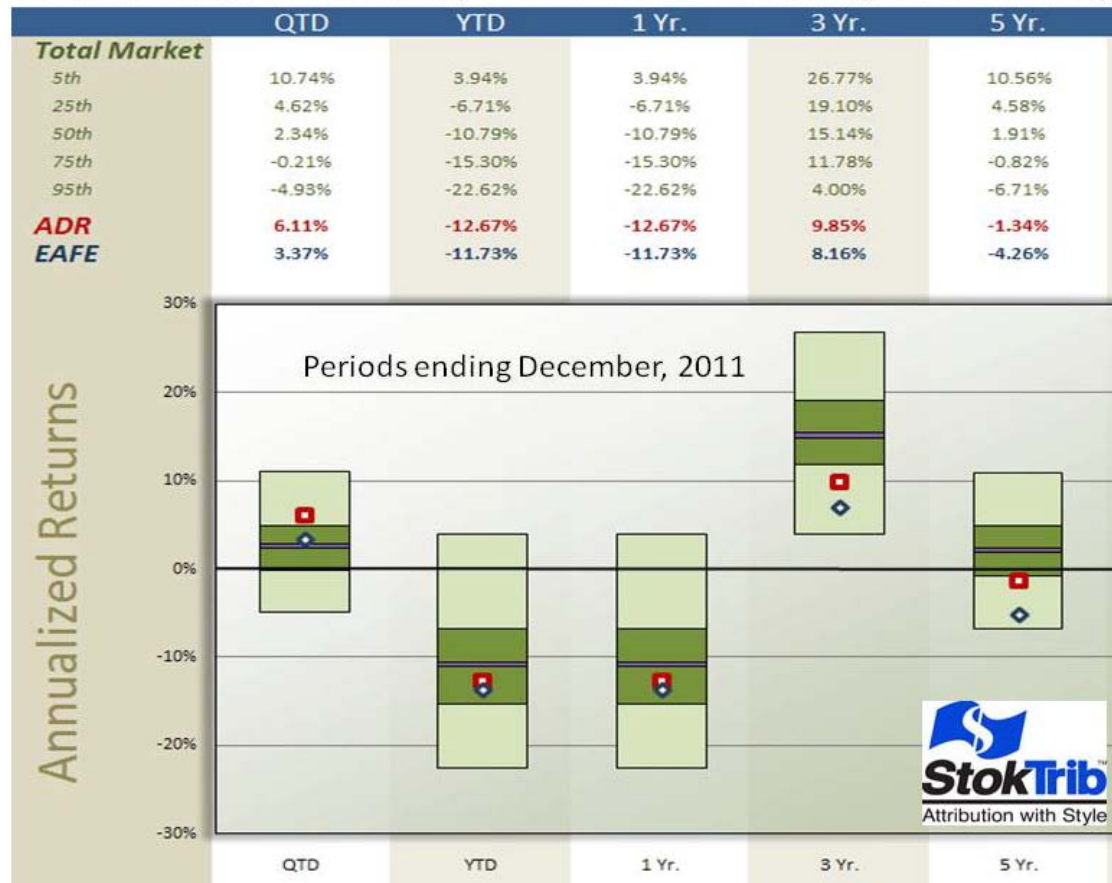
## Performance Evaluation of ADR Managers

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?

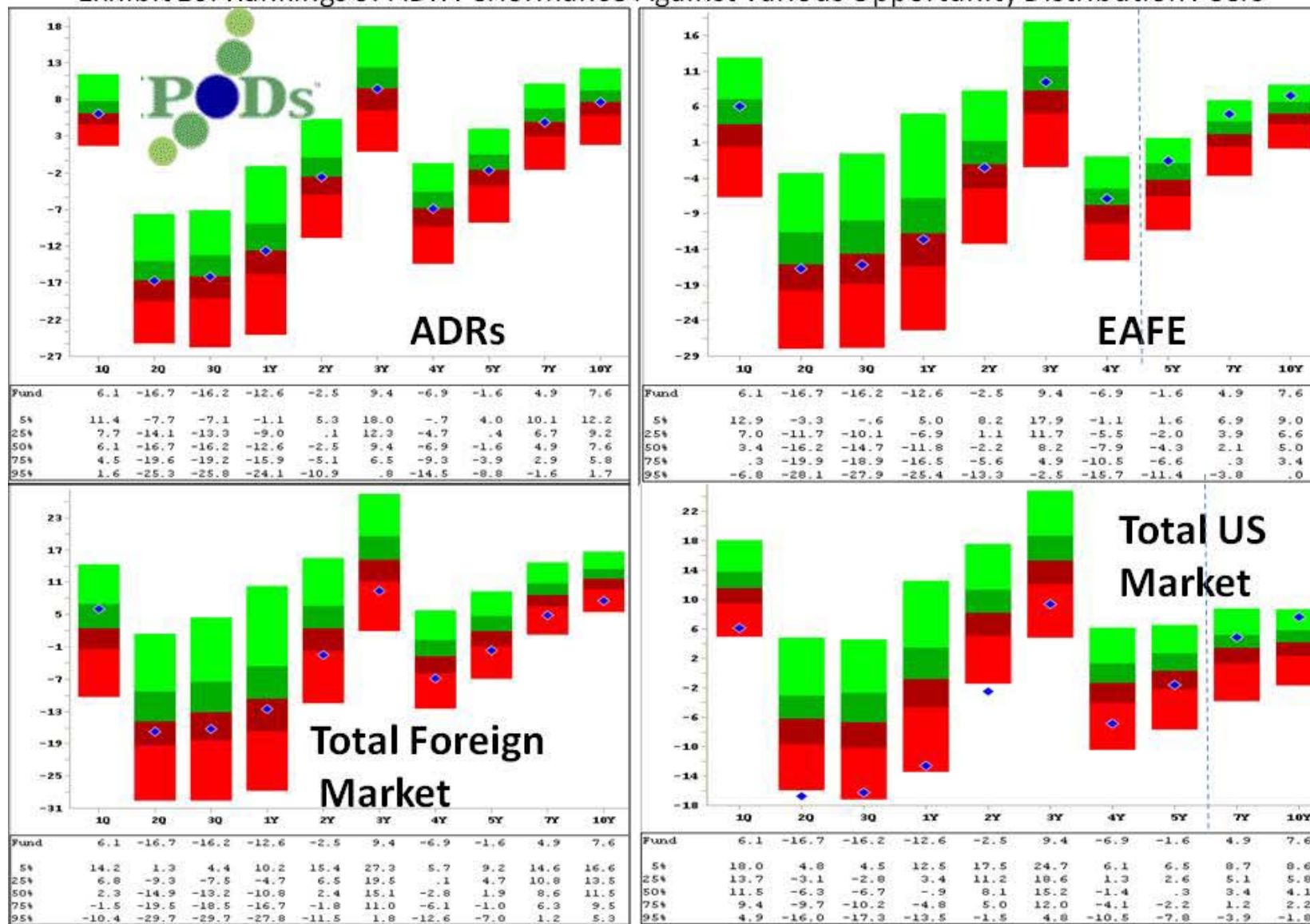
The 2<sup>nd</sup> question is best answered by contrasting the manager's performance to the opportunities available to the manager's mandate. For example, the mandate could be to outperform EAFE, which the preceding suggests should be easy. By contrast, a mandate to perform well against the total foreign market would have been a significant challenge in the past 5 years. This challenge can be viewed as the cost of the constraint to use ADRs, and argues for an evaluation against the ADR opportunity set. Exhibit 9 puts the three mandates into perspective.

Exhibit 9: Performance summary of ADRs and EAFE ranked against Total Foreign



As a further guide, Exhibit 10 provides universes for four possible mandates: ADRs, EAFE, Total Foreign Market and Total US Market, and plots the returns on the total ADR universe.

Exhibit 10: Rankings of ADR Performance Against Various Opportunity Distribution Peers



## Conclusion

Exposure to foreign markets has been a good thing for U.S. investors so far in this Century, although the past five years have been mixed, with the best choice being the total unrestricted foreign market, encompassing smaller companies and non-EAFE regions. The unconstrained total foreign market has performed best. 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 [Due Diligence](#) for our thoughts on the fiduciary responsibilities of those who select money managers. If you're going to take the time and energy to select an active manager you should pick the best you can because manager selection is a fiduciary act.