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ADR characteristics and performance in international and global indexes

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Abstract

This study examines the characteristics and performance of American depository receipts (ADRs) in international indexes and the role of ADRs on foreign ordinaries as a global diversifier. We find that ADRs in Europe, Australasia and the Far East are tilted toward three common factors: giant cap, dividend yield and UK stocks. We also find that portfolio combinations of ADRs and US equities provide inefficient diversification opportunities relative to an efficient frontier analysis of the S&P500 and Global 700, the latter portfolio consisting of a diversified mix of ADRs and non-ADR-based foreign shares. Our findings on ADR characteristics are consistent with prior research, whereas our ADR performance findings are

inconsistent with prior research. Caveats apply, notably for yield-seeking taxable accounts.

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Notes

1. International indexes such as EAFE and S&P Global 700 consist of foreign stocks (and ADR-based derivatives thereon), whereas global (world) indexes such as S&P Global 1200 include a mix of US and non-US stocks, generally as a proportion of global market cap.
2. ADRs on foreign shares are listed on the NYSE, ASE and NASDAQ.
3. An ADR can be unsponsored; a US bank buys shares of a foreign corporation, does not register them with the US SEC and deposits them at a custodian bank. However, such ADRs are increasingly uncommon and cannot be listed on the major American stock exchanges because they do not comply with listing requirements. In addition, there are Rule 144A Depositary Receipts, which are special ADRs that can only be sold to Qualified Institutional Buyers as a private placement.
4. On 15 November 2007, the US Securities and Exchange Commission announced new rules for the listing of foreign shares on US exchanges. As such, foreign companies that prepare their financial statements according to

International Financial Reporting Standards (IFRS) as accepted by the International Accounting Standards Board (IASB) no longer have to prepare or reconcile their financial statements to US GAAP.

5. In our displays (figures) of ADR characteristics, the percentage of ADR and non-ADR-based foreign stocks in EAFE add to '100' by factor buckets. For example, in [Figure 1](#), ADRs on UK stocks make up 81 per cent of UK stocks covered in the EAFE index. For convenience, we refer to this factor-bucket-percentage as the ADR-to-non-ADR ratio.
6. In this section, we use an ADR breakout of the S&P Global 700 index. An ADR breakout of EAFE would be preferred for transition with our prior section on ADR characteristics. However, we (and Delaware Investors) were unable to find a readily available series of monthly returns on an ADR breakout of the EAFE index.
7. The issue of whether ADRs provide efficient or inefficient diversification should be framed relative to another international index. Also, if the ADR portfolio were a subset of a broader index, then modern portfolio theory would argue that the subset (ADR-based or otherwise) will have sub-optimal portfolio characteristics. For example, a broader index consisting of ADRs and non-ADR-based foreign ordinaries should have everywhere higher risk-adjusted portfolio returns. We demonstrate this MPT prediction with asset mixes of the S&P500 and Global 700 versus mixes of the S&P500 and an ADR breakout of the Global 700 in our analysis that follows.
8. Exceptions and conditions apply; also our comments on dividend and capital gain taxation should not be interpreted as providing tax or investment advice.

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