CLARIFYING CONFUSION: AMERICAN DEPOSITORY RECEIPTS (ADRS) HAVE CURRENCY RISK

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Lately, we have been talking with a lot of clients about our family of hedged equity ETFs, each of which invests in a basket of foreign equities and then neutralizes, or hedges, the exposure to the currency. One common question we hear is, "Can't I achieve the same thing by investing in a basket of ADRs?" It is a common misconception that, because an ADR is traded in U.S. dollars in the United States, there is no exchange-rate risk. But that's not the case. Here's why. ADRs are created by a global bank that owns a large number of an international firm's local shares. The bank sets an ADR conversion rate, meaning that an ADR share is worth a certain number of local shares. This conversion rate establishes the link between the ADR security and the locally traded security. To preserve this conversion relationship over time, movements in the exchange rate of the home country's currency versus the U.S. dollar must automatically be reflected in the price of the U.S.-traded ADR in U.S. dollars. For example, if the local price of the foreign security does not change, but the exchange rate measured versus the U.S. dollar declines by half, the U.S.-traded ADR price would also decline by half. The converse is true as well: a gain in the exchange rate would mean an increase in the U.S.-traded ADR price. Without this exercise, it would be impossible to preserve the conversion rate established by the bank. Let's analyze how this relationship worked for one Japanese company since the start of Abenomics. We selected the largest Japanese company by market capitalization, Toyota, to illustrate this example. A comparison of the cumulative movement in the ADR price for Toyota with the local stock price for Toyota provides a clear illustration of how currency moves are factored into the ADR price. While Toyota's stock price has appreciated 74.6% cumulatively since the start of Abenomics, the ADR price has appreciated only 33.7%.[1] Why? The yen's exchange rate versus the U.S. dollar depreciated by almost 24% over this period; the ADR's appreciation was thus significantly mitigated by the yen's depreciation. The ADR price approximates the ADR conversion rate (2 to 1), multiplied by the price of Toyota in yen and converted into U.S. dollars. Investors should not expect the ADR conversion relationship to be exact because the ADRs are traded during U.S. hours, when the Japanese markets are closed. It should be clear from this example that Toyota's ADRs, despite being traded in the United States, were impacted by the yen-to-dollar exchange rate.

	11/30/2012	10/28/2014	Cumulative Change (11/30/12-10/28/14)
Toyota Local Price (in yen)	¥3,535	¥6,172	74.6%
ADR Conversion Rate*	2	2	N/A
USD per yen**	$0.0121	$0.0092	-23.7%
Toyota in USD (Toyota Local x USD per yen)	42.86	57.07	33.2%
ADR Price	$86.08	$115.10	33.7%

Sources: WisdomTree, Bloomberg, 11/30/12–10/28/14. Past performance is not indicative of future results.
*ADR conversion rate: Established by the global bank issuing the ADRs; any changes must be an active decision by the bank.**Reverse quotation of usual yen-per-dollar exchange rate between the U.S. dollar and Japanese yen was done in an attempt to make the chart more intuitive.

Many assume that because ADRs trade in U.S. dollars in the United States, they eliminate currency risk. But because of the way ADRs are structured, they still contain currency risk, as we illustrated. For those looking to hedge the currency risk in their foreign stocks, ADRs are no substitute for strategies that actually employ a specific currency-hedging program.

[1]Sources: WisdomTree, Bloomberg, 11/30/12–10/28/14.

Important Risks Related to this Article

ETFs are subject to ordinary brokerage commissions. Investments in currency involve additional special risks, such as credit risk and interest rate fluctuations. Toyota Motor Corp had a 5.3% weight in the WisdomTree Japan Hedged Equity Index and a 10.4% weight in the WisdomTree Japan Hedged Capital Goods Index, as of 10/28/14.

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DEFINITIONS

Hedge : Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.

ADRs : American Depository Receipts, shares of a firm incorporated outside the U.S. but issued by a global bank and traded in the U.S., denominated in U.S. dollars.

Global bank : Large financial institution capable of making bulk-sized international transactions.

Exchange rate : The exchange of one currency for another, or the conversion of one currency into another currency.

Abenomics : Series of policies enacted after the election of Japanese Prime Minister Shinzo Abe on December 16, 2012 aimed at stimulating Japan's economic growth.

Market Capitalization : Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.