Overseas investing at home

In a time of market volatility, the importance of a diversified portfolio can never be overstated. One way to do that, by adding an "international" component to one's holdings, has become a trend in the last two decades.

Access to foreign markets comes in a variety of ways. One approach is to invest in a professionally managed international or global mutual fund. (The former invests primarily in securities listed abroad; the latter spans the world, including the U.S.) Although purchasing shares in an international or global fund is relatively uncomplicated and inexpensive, it leaves investors with no control over the makeup of their foreign investments.

A second approach is to invest directly in the foreign-based stocks themselves. Generally, this path is more complicated and, in addition, may be costly. The choice of stocks may be more narrow for an investor, and safety could be an issue. Generally, only foreign stocks listed on American exchanges are subject to the kinds of reporting and disclosure rules required by the Securities and Exchange Commission (SEC).

For some investors neither approach may seem attractive. A third, the purchase of American Depository Receipts (ADRs), may seem a reasonable alternative.

ADRs at a glance

An ADR is a negotiable instrument representing an ownership interest in the securities of a non-U.S. publicly traded company. An ADR is created when an investment bank arranges to buy the shares on a foreign market and issue the ADRs on the U.S. markets. Each ADR represents one or more shares, or a fraction of a share, of the underlying stock. They are quoted and traded in U.S. dollars, and because they are considered U.S. securities, they are settled according to the procedures governing the U.S. market.

Because they are priced in U.S. dollars, ADRs are attractive from a cost perspective. Investors don't have to worry about some of the expenses that come with cross-border transactions—international settlement, global custody, foreign brokerage and currency conversion fees, for instance.

Generally, ADRs offer the same economic, corporate and voting rights as those of U.S. investors who purchase individual shares of foreign companies. But, often, things are less complicated. For example, dividends paid in foreign currency are converted and paid in U.S. dollars.

Look at the whole picture

The performance of ADRs should correlate closely with that of the underlying stock traded on the foreign exchange. What an investor has to keep in mind, however, is that ADRs are subject to currency risk. For example, when the value of the U.S. dollar appreciates in relation to the foreign country's currency, because of the stronger dollar, the real return to a U.S. dollar-based investor will be less than the return to the investor who is trading in the foreign currency. In short, the currency risk makes the return on ADRs more volatile.

Taxes may be another area of concern with the purchase of ADRs (or any foreign shares for that matter). Dividends are subject to the withholding rules of foreign taxes. The amount of the withholding varies. A key factor is whether the foreign country has a tax treaty with the U.S. In that instance, withholding may be 15%. Otherwise, rates can be substantially more. Investors may apply for a refund to bring the withholding down to 15%, but the procedure involves filing a particularly cumbersome tax form.

Information gaps

Other aspects of investing in ADRs may, for some investors, offset the benefit of diversification. As pointed out by the American Association of Individual Investors, share statistics (for example, price-earnings ratios, earnings per share and shares outstanding) may be hard to interpret. Although large multinational companies prepare their statements in a number of formats and currencies, when only the native language is used, annual reports and financial statements will have to be translated.

Finally, not all ADRs are created equal. Exchanged traded ADRs offer the investor the most information and operate similarly to a U.S. security. But there are many ADRs that are traded off an exchange. Most of these ADRs are "sponsored," meaning that they were created with the consent of the foreign company. Thus, an investor can expect to receive an annual report and some kind of regular (but, perhaps, not very frequent) earnings reports. However, these off-exchange ADRs are not subject to U.S. accounting or SEC rules. "Nonsponsored" ADRs trade without the consent of the foreign company and, as would be expected, provide investors with very limited information.

For many investors, international investing with the use of ADRs may be an appealing way to diversify a portfolio, especially for the investor who enjoys the research aspect of choosing an investment, or who is willing to rely upon the advice of professionals. But, truly, it's a

case of balance: Diversification is an important goal but it must be attained within the framework of the investor's acceptable comfort level for risk.

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Any developments occurring after January 15, 2007, are not reflected in this article.