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DR Advisor Insights

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ADR Liquidity – There's more than meets the eye

Introduction

The portfolio manager of a New York-based institutional investor managing $20 billion in equity assets begins researching a European company as a prospective investment. When she enters into her trading terminal the symbol of the company's U.S.-listed ADR[1], she notices that it trades an average of 22,000 ADRs a day. At a price of $14.35, that is only $315,700 worth of ADRs changing hands each day.

On the surface it appears the portfolio manager could never invest in this seemingly illiquid ADR, as the price would start running away from her almost as soon as the firm's traders started giving brokers buy orders. But there is far more liquidity than meets her eye, as will be explained later.

ADRs trade on U.S. stock exchanges or in the over-the-counter market (OTC)[2]. However, unbeknownst to some investors and brokers, there is an alternative means to invest in non-U.S. companies via ADRs.

Depositary banks issue ("create") ADRs for buyers and cancel ("terminate") them for sellers, a cross-border process that taps into the often deeper liquidity of non-U.S. companies' "home" equity markets[3]. Therefore it could be said that the liquidity of a company's ADRs is, in effect, at least equal to the liquidity of its shares in its home market. Accordingly, an investor should not look at U.S. trading volume alone when evaluating a non-U.S. company or the use of ADRs as a means to invest in it.

Cross-border liquidity via ADR issuance and cancellation

To invest in a non-U.S. company via ADRs, an investor has several options. A common method is to buy the company's ADRs through the NYSE, NASDAQ or OTC (see "Buys ADRs" in the top portion of the diagram on the following page). The other is to have a depositary bank issue ADRs to the investor, a simple and straightforward process.

In brief, a U.S. broker orders, on behalf of an investor, the shares of a non-U.S. company. (See step 1 in the diagram). These shares are purchased by the broker's overseas office or via another broker located in the foreign market (step 2). The shares are then deposited with a custodian located in this market (step 3).

Overview of ADRs

An ADR is a financial instrument that has facilitated cross-border investing since J.P. Morgan created the first one in 1927. At the end of 2011, $607 billion in institutional equity ownership was held through ADRs. During that year, $3.2 trillion worth of ADRs traded globally, further evidencing the widespread use of this investment vehicle.

Equity positions in many of the world's most well-known non-U.S. companies are held in ADR form because of the many conveniences this facility affords investors across the globe. For example, ADRs trade, clear and settle[4] in U.S. dollars and dividends are paid in this currency. Also, custody costs can often be lowered when using ADRs, particularly with respect to emerging market equities. Additionally, because ADRs are traded and regulated in the U.S., they can mitigate many of the risks typically associated with holding emerging market equities; this is one of the reasons why some investment charters require using ADRs to invest in non-U.S. companies.

All of these features make ADRs a convenient alternative to trading in the underlying shares of non-U.S. companies. And because ADRs facilitate investment, many use this instrument to list and raise capital in the U.S.

After receiving a confirmation from the custodian (step 4), the depositary bank issues to the U.S. broker ADRs that represent an equivalent number of the deposited shares[5] (step 5). These ADRs are then held with the investor's U.S. broker or custodian.

Whenever the investor wishes to reduce or liquidate this investment position, the process is simply reversed. The ADRs are returned to the depositary bank and canceled, with the underlying shares subsequently delivered to a foreign broker for sale in the local market. Alternatively, the investor could sell the ADRs via a U.S. stock exchange or OTC. The issuance and cancellation process is generally known as I&C.

Each year billions of ADRs are traded on U.S. stock exchanges and in the OTC market, offering the same price transparency as their underlying shares and further demonstrating the instrument's fungibility. However, in some instances ADRs can be more liquid than the underlying shares in a non-U.S. company's home market, particularly in emerging market countries where the pools of capital are significantly smaller than those in the U.S.

It should be noted that an investor can hold a combination of ADRs and underlying shares of a company. Investors do this because the advantages of holding one over the other can fluctuate over time; such advantages are considered as part of the best-execution process that brokers aim to achieve for investors. Also, an investor may substitute – via the I&C process - one instrument for another at any point in time after the initial investment position has been built.

Other options for investing in non-U.S. companies via ADRs

ADRs can also be acquired (or disposed of) via a crossbook market. Depending on market conditions, a depositary's cross book can offer cost advantages over I&C or trading ADRs on a stock exchange or OTC. Securities lending can also be employed with respect to ADRs, providing yet another source of liquidity.

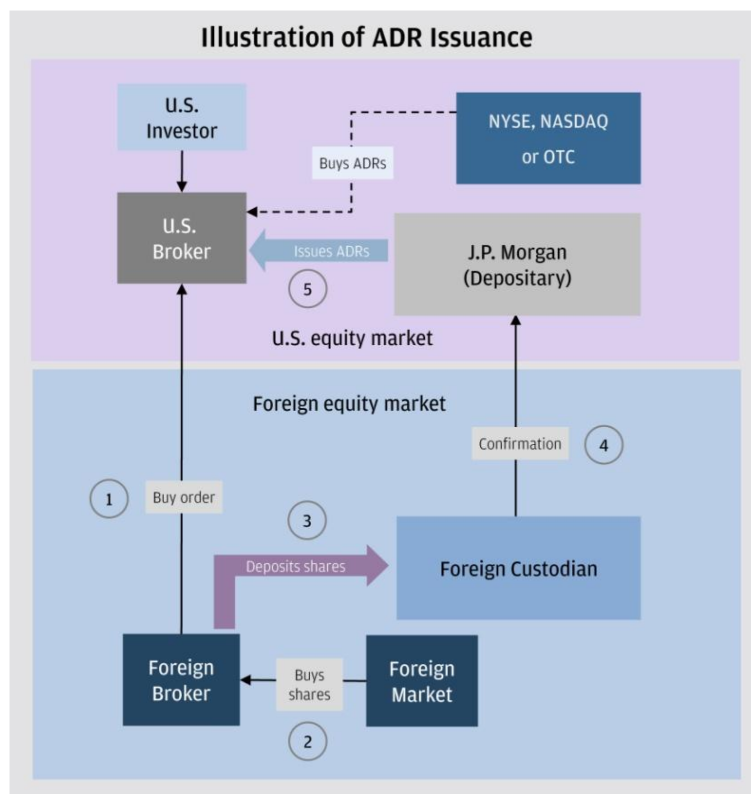
To build or reduce an investment position over time, it is not uncommon for investors and their brokers to alternate between these methods, trading on a stock exchange or OTC, and I&C, each offering best execution at different points in time.

Settlement gaps can present challenges when investing outside the U.S. equity market, due to different settlement systems in overseas securities markets. However, a depositary bank can pre-release ADRs (for issuance purposes) to mitigate these challenges. Pre-cancellation is also available in this regard, if an investor wishes to reduce or liquidate an ADR position.

Internal trading rules can unintentionally preclude ADRs

At some investment managers, ADRs may not be considered as a means of investment because internal trading rules are based on U.S. trading volume alone, with respect to determining if sufficient liquidity exists. In such a case, an investor is limiting its ability to minimize trading costs and optimize the price and timing of its trades in non-U.S. companies.

To learn more about ADRs, visit adr.com or contact James Reeves at (212) 552-8928 or james.wi.reeves@jpmorgan.com



Conclusion

Seemingly low average daily volume of an ADR traded on a U.S. stock exchange or OTC can be a misleading indication of an institution's ability to achieve best execution. If U.S. ADR volume is low, an investor might unnecessarily screen out a non-U.S. company as a potential investment, or simply trade in the company's ordinary shares without determining if best execution could be achieved through the issuance (and cancellation)[6] or crossbook of ADRs or via securities lending.

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[1] American depositary receipt
[2] Global Depositary Receipts trade on stock exchanges worldwide.
[3] Home market refers to the financial market where the underlying domestic shares of a non-U.S. company trade. Typically, this is the primary stock exchange of the country in which the company is incorporated.
[4] In the U.S., ADRs are settled via DTC. In Europe, GDRs are settled via Euroclear and Clearstream.
[5] The ratio of ADRs to underlying shares is usually 1:1.
[6] If an investor wished to reduce or exit a position in the future, the cancellation of ADRs could be employed to draw on the liquidity of the home equity market in the same way that the issuance process does.