

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

Jeremy Schwartz — Global Chief Investment Officer  
11/03/2014

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%.<sup>1</sup> 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. <sup>1</sup>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.

For standardized performance and the most recent month-end performance click [here](#) NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

For more investing insights, check out our [Economic & Market Outlook](#)

View the online version of this article [here](#).

## **IMPORTANT INFORMATION**

**U.S. investors only: Click [here](#) to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.**

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages ([www.msci.com](http://www.msci.com))

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Kara Marciscano, Jianing Wu and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

## 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 Depositary 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.