Globalization is the dissolution of barriers to trade and the tendency of the world’s businesses to integrate customs and values. Globalization is making it increasingly easy to travel, correspond and even invest in other countries.

Investing money in your own country's stock market is relatively simple. You call your broker or login to your online account and place a buy or sell order. Investing in a company that is listed on a foreign exchange is much more difficult. Would you even know where to start? Does your broker provide services in other countries? For example, imagine the commission and foreign exchange costs on an investment in Russia or Indonesia.

However, now there is an easy way around this through American depositary receipts (ADRs). More than 2,000 foreign companies provide this option for U.S. and Canadian investors interested in buying shares. In this tutorial, we'll explain how this investment vehicle works and help you sort out whether it could be a good choice for your portfolio.
What Is An ADR?

Introduced to the financial markets in 1927, an American depositary receipt (ADR) is a stock that trades in the United States but represents a specified number of shares in a foreign corporation. ADRs are bought and sold on American markets just like regular stocks, and are issued/sponsored in the U.S. by a bank or brokerage.

ADRs were introduced as a result of the complexities involved in buying shares in foreign countries and the difficulties associated with trading at different prices and currency values. For this reason, U.S. banks simply purchase a bulk lot of shares from the company, bundle the shares into groups, and reissues them on either the New York Stock Exchange (NYSE), American Stock Exchange (AMEX), or the Nasdaq. In return, the foreign company must provide detailed financial information to the sponsor bank. The depository bank sets the ratio of U.S. ADRs per home-country share. This ratio can be anything less than or greater than 1. This is done because the banks wish to price an ADR high enough to show substantial value, yet low enough to make it affordable for individual investors. Most investors try to avoid investing in penny stocks, and many would shy away from a company trading for 50 Russian rubles per share, which equates to US$1.50 per share. As a result, the majority of ADRs range between $10 and $100 per share. If, in the home country, the shares were worth considerably less, then each ADR would represent several real shares.

There are three different types of ADR issues:

- **Level 1** - This is the most basic type of ADR where foreign companies either don't qualify or don't wish to have their ADR listed on an exchange. Level 1 ADRs are found on the over-the-counter market and are an easy and inexpensive way to gauge interest for its securities in North America. Level 1 ADRs also have the loosest requirements from the Securities and Exchange Commission (SEC).

- **Level 2** - This type of ADR is listed on an exchange or quoted on Nasdaq. Level 2 ADRs have slightly more requirements from the SEC, but they also get higher visibility trading volume.

- **Level 3** - The most prestigious of the three, this is when an issuer floats a public offering of ADRs on a U.S. exchange. Level 3 ADRs are able to raise capital and gain substantial visibility in the U.S. financial markets.

The advantages of ADRs are twofold. For individuals, ADRs are an easy and
cost-effective way to buy shares in a foreign company. They save money by reducing administration costs and avoiding foreign taxes on each transaction. Foreign entities like ADRs because they get more U.S. exposure, allowing them to tap into the wealthy North American equities markets.

**Determining Price**

Now that you've learned how an ADR is established and sold to the public, let's delve a little deeper. In this section, we'll examine how the price of an ADR is determined.

Let's use an example to give you a better idea about how the ADR process works. Suppose a recent boom in the popularity of Bloody Mary drinks has increased the prospects for the vodka industry. Russian Vodka Inc. wants to list shares on the NYSE to gain exposure to the U.S. market and to tap into the growing demand for vodka.

Russian Vodka already trades on the Russian Stock Exchange at 127 Russian rubles, which, at this time, is equivalent to US$4.58. Let's say that a U.S. bank purchases 30 million shares from Russian Vodka Inc. and issues them in the U.S. at a ratio of 10:1. This means each ADR share you purchase is worth 10 shares on the Russian Stock Exchange. A quick calculation tells us that the new ADR should have an issue price of around US$45.80 each (10 times $4.58).

Once an ADR is priced and sold on the market, its price is determined by supply and demand, just like an ordinary stock. However, if the U.S. price varies too far from the Russian price after taking the currency exchange rate and the ratio of ADRs to home country shares into account, an arbitrage opportunity may arise. ADRs tend to follow the general trend of the home country shares, but this is not always the case.

ADRs present many other unique risks to investors; we'll examine these in the following section.

**Risks**

There are several factors that determine the value of the ADR beyond the performance of the company. Analyzing these foreign companies involves further scrutiny than merely looking at the fundamentals. Here are some other risks that investors should consider:
Political Risk - Ask yourself if you think the government in the home country of the ADR is stable? For example, you might be wary of Russian Vodka Inc. because of the characteristic instability of the Russian government.

Exchange Rate Risk - Is the currency of the home country stable? Remember the ADR shares track the shares in the home country. If a country's currency is devalued, it will trickle down to your ADR. This can result in a big loss, even if the company had been performing well.

Inflationary Risk - This is an extension of the exchange rate risk. Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling. Inflation can be a big blow to business because the currency of a country with high inflation becomes less and less valuable each day.

Conclusion

With globalization dissolving borders, it only makes sense that we have the ability to invest in foreign entities. Many nations who are striving to become industrialized are undervalued compared to the levels they will eventually reach.

Many people, therefore, consider ADRs an undiscovered gem in the financial markets. Diversification does not stop at just investing in different types of stocks or bonds. By investing in different countries, you gain the potential to capitalize on emerging economies, which hopefully leads to more green in your pocket.

Let's recap:

- ADR is an acronym for American depositary receipt.
- ADRs trade just like stocks but represent shares of a foreign company trading on a foreign stock exchange.
- ADR shares float on supply and demand just like a regular stock.
- There are three types of ADRs - Level 1, Level 2 and Level 3. Levels 1 and 2 are listings in the U.S., while Level 3 ADRs are public offerings to investors.
- Remember that there are other risks associated with buying ADRs, including inflationary risk, political risk and exchange rate risk.