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GLOBAL EQUITY

Investment Management
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Why International Leaders ADR for Your International Exposure

American Depositary Receipts (ADRs) are a cost-effective way to gain international equity exposure, and when combined with our Leaders strategies, we believe the case for ADRs is even more compelling. In this Q&A, we explain why investors seeking to diversify portfolio exposure beyond U.S. companies may want to consider ADRs.

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Portfolio Manager,
Global Research Analyst
Alaina Anderson, CFA, Partner

Introduction

Alaina Anderson, CFA, Partner

ADRs—which are U.S. dollar-denominated securities that trade in the United States but represent shares of foreign corporations—are a cost-effective way to gain international equity exposure.

When combined with our Leaders strategies, which seeks best-in-class companies across geographies, market capitalizations, and corporate lifecycles, we believe the case for ADRs is even more compelling.

William Blair has significant experience in this arena, launching its first international equity mutual fund in 1992. As of December 31, 2020, we manage $69.7 billion in assets across our investment platform ($44.5 billion of those assets in non-U.S. equities).

In this Q&A, Alaina Anderson, CFA, partner, a portfolio manager on our International Leaders ADR strategy, explains why investors seeking to diversify portfolio exposure beyond U.S. companies may want to consider ADRs.

> "William Blair Investment Management was a pioneer in emerging markets investing, and today we have several strategies dedicated to emerging markets, and one dedicated to China."

Alaina Anderson, CFA, Partner

Why International

Before we get started on ADRs, why might investors consider international equities?

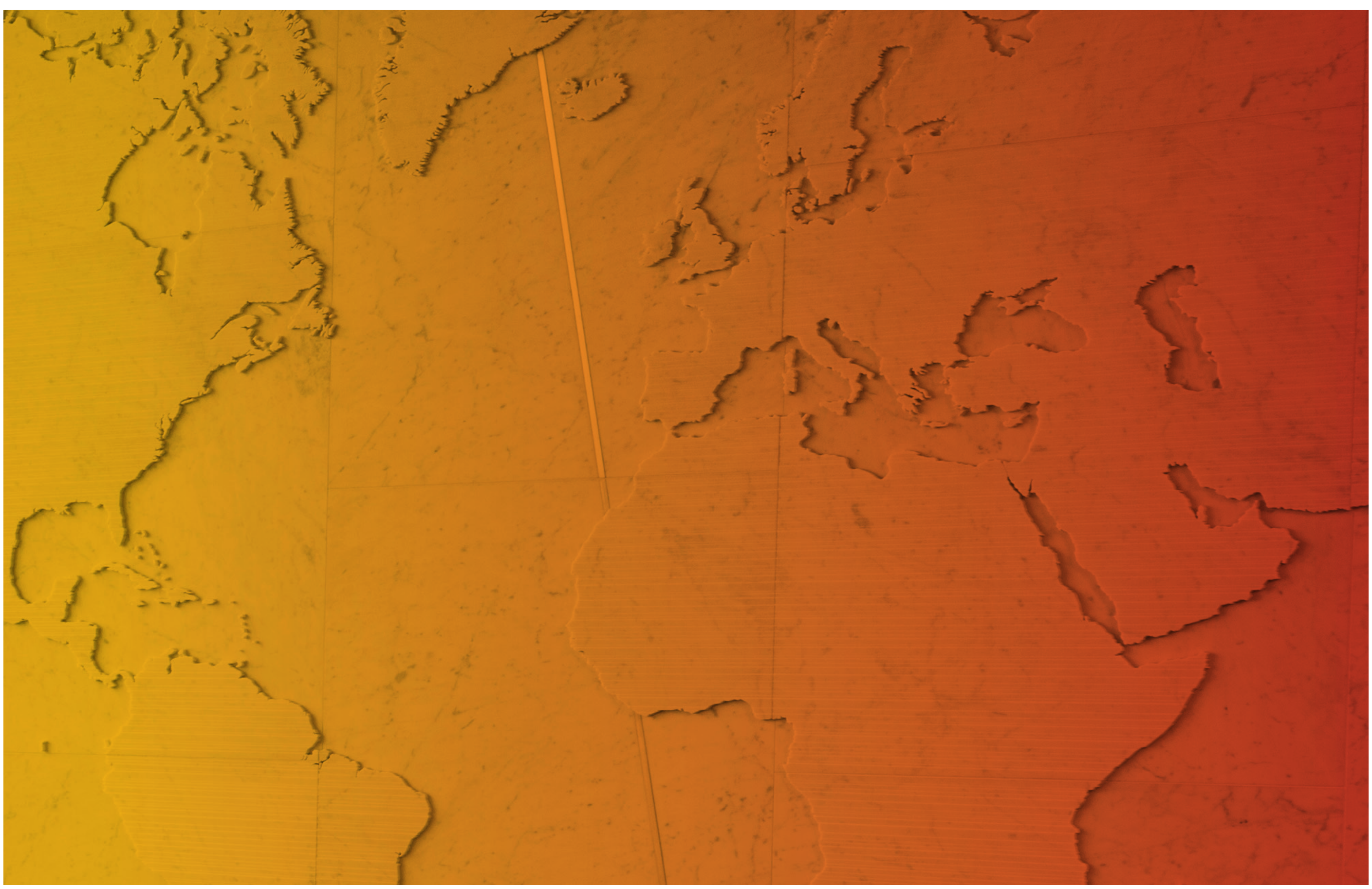
Alaina: I wrote a white paper that goes into this topic in great depth, but to recap, an active approach to international investing unlocks a broad opportunity set, allowing investors to search for the best investment ideas around the world. And there are three key pillars underlying this thesis.

Could you briefly outline those pillars?

Alaina: First, the universe of high-quality growth stocks outside the United States is large and growing, and this is important because quality—specifically, what we call sustainable value creation—is a far more significant contributor to equity returns than other factors, such as geography.

Second, expectations for earnings growth and return on invested capital (ROIC) have become more favorable outside the United States—and our outlook for growth in key industries suggests accelerating demand and emerging business models abroad.

Third, the regulatory environment outside the United States is more conducive to the proliferation of disruptive business models.



Why ADRs

Why might investors who are interested in international exposure consider ADRs?

Alaina: ADRs are an easy, relatively liquid way for U.S. investors to own foreign stocks. Developed to minimize the complexities involved in buying international equities, ADRs provide potential cost savings for U.S. investors through reduced administrative fees and registration requirements. In addition, an ADR lets you own individual securities within a separately managed account (SMA), providing all the benefits of direct ownership.

How representative are ADRs of the international universe and opportunity set?

Alaina: The ADR universe is large, robust, and growing as more companies list ADRs. According to our analysis, nearly 69% of the weight of the non-U.S. equity universe can be replicated by ADRs. And our focus on high-quality companies allows us to build a thoughtful, diversified international equity portfolio that offers compelling alpha potential.

How do you address potential liquidity risk in an ADR portfolio?

Alaina: A critical part of our process is risk management. When investing in ADRs, we focus on those with higher liquidity—those listed on major U.S. stock exchanges such as the New York Stock Exchange or the Nasdaq, and they are generally more liquid as a result. We occasionally invest in ADRs that are only traded on the over-the-counter (OTC) market, but only if we are confident in the liquidity profile based on historical trading activity.

Should investors be concerned about the potential for the delisting of Chinese ADRs?

Alaina: ADR investors should always consider the potential for ADR issuers to delist from major stock exchanges and move to the OTC market. During the 2008 financial crisis, for example, a number of ADRs were abruptly delisted, creating liquidity issues for a period of time.

That potential exists with China today, but I believe the alpha opportunity that comes from holding China ADRs outweighs the overhang from potential delisting.

As background, China does not allow foreign regulators access to audit documents of overseas-listed Chinese companies. U.S. regulators have been trying to address this for some time, and in May of 2020, the U.S. Senate unanimously passed the Holding Foreign Companies Accountable Act, which mandates that if the U.S. Securities and Exchange Commission (SEC) is unable to audit foreign entities within three years of the new law being implemented, the foreign entity would be delisted from the U.S. stock exchanges.

This would mean a potential delisting in 2023 at the earliest. But again, we think the potential benefits of Chinese ADRs (which make up nearly 12% of the ADR universe) outweigh the risks.

We also have deep expertise in emerging markets. William Blair Investment Management was a pioneer in emerging markets investing, and today we have several strategies dedicated to emerging markets, and one dedicated to China. We manage $19.4 billion in emerging markets securities across all strategies, $13.7 billion in dedicated emerging market strategies, and $8.0 billion in Chinese equities (including $2.3 billion in China A-Shares) across all strategies as of December 31, 2020. And our teams work closely to share knowledge and expertise.

> "Our focus on high-quality companies allows us to build a thoughtful, diversified international equity portfolio with ADRs."
>
> **Alaina Anderson, CFA, Partner**

Why William Blair

What makes William Blair a compelling manager?

As of December 31, 2020, we have 50 dedicated analysts and 34 portfolio managers, and 37 of our 84 portfolio managers and analysts are partners. And our broad-based, 100% active employee-owned firm creates an environment in which investment professionals can thrive practicing the profession of investment management and are incentivized to seek long-term success for clients. That means our colleagues are long tenured. Portfolio managers average 24 years in the industry and 11 at William Blair; analysts average 16 years in the industry and 9 at William Blair.

How do you work with the broader global equity team?

Alaina: The William Blair global equity investment approach is anchored on the idea of "One Team, One Philosophy, One Process." Whether our teammates are in Chicago or London, in the office or on the road, all of our professionals share an identical investment philosophy and a single unified process. Our globally inclusive perspective, our systematic research tools, and our fundamental identification of sustainable value creation at the company level underpin our process.

Analysts provide research recommendations in an open forum where dialogue and collaboration are encouraged. Portfolio managers allocate research ideas based on portfolio requirements. As an analyst and portfolio manager, I participate in daily research meetings, where we discuss news flow impacting portfolio holdings and new ideas, as well as portfolio manager meetings, where opportunities for greater alignment across the platform are shared.

International Leaders boasts a strong track record, and asset-gathering momentum in the strategy has been among the strongest on our platform. The tight alignment between the two strategies is designed to better leverage the best thinking across our platform and allow for close collaboration between the International Leaders and International Leaders ADR portfolio managers. We believe this alignment has the potential to drive superior risk-adjusted returns over time.

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>
> Alaina Anderson, CFA, Partner

What are the key differentiators of your International Leaders ADR strategy?

Alaina: The International Leaders ADR portfolio seeks to identify the best sustainable value creators, or "Leaders," across industries and regional markets all over the world.

What we call Leaders are not simply steadily earning companies gobbling up market share. We purposefully seek to diversify our holdings across three uniquely defined corporate lifecycle stages, and thus tend to have ample exposure to mid- and smaller-cap companies.

We invest in disrupters—companies in their early development but beyond the start-up phase. We call those "emergent growers."

We also invest in companies that graduate from the emerging growth phase, typically having more certain growth rates in expanding markets and a more proven business model. We call those "expanding growers."

Lastly, we invest in established, stable market-share owners that have strong, recognizable brands. We call those "sustained growers."

By creating portfolios focused on leading companies with intentional attention to diversity across the corporate lifecycle, we believe that we have the potential to generate superior risk-adjusted returns over time.

The way we integrate environmental, social, and governance (ESG) analysis is also a key differentiator. ESG factors are inextricably linked with our fundamental assessment of a company's ability to create sustainable long-term value.

How do you identify Leaders?

Alaina: Leaders are companies that we believe are, or are becoming, the best sustainable value creators in the world. Their key attributes are that they (a) exude corporate attributes that support an enduring and sustainable competitive advantage, (b) have a superior product or service offering that delivers tangible or intangible benefits to customers, and (c) deliver consistent reinvestment of cash flow at rates of return that exceed their cost of capital.

Analysts identify Leaders within their individual coverage universe based on these conditions and tag companies where they view that the designation is justified. These designated Leaders then create the investment universe or eligibility list for our Leaders strategies.

Our internal ESG analysis and scores also inform our identification of Leaders. Rather than having a minimum threshold or hurdle for the ESG scores of our Leaders, we are looking to understand the level of ESG integration throughout the firm as well as the momentum or direction of travel in terms of adoption—not only the commitment but actual performance.

Can you expand on how you integrate ESG analysis in identifying these Leaders?

Alaina: We do it systematically by requiring our analysts to identify and document the relevant ESG risks and opportunities for every company that has been recommended for purchase, and assign a qualitative score of 1 (best) to 5 (worst) based on their assessment of how those issues are being managed.

This process is supported by an industry materiality framework that we developed internally to help guide our identification of key issues within each pillar (E, S, and G), as well as potential engagement questions to address with company management and directors.

Importantly, our ESG analysis provides greater conviction in our outlook for growth and returns, and our assessment of long-term sustainable value creation potential. This may derive from a differentiated product or service that enables greater energy efficiency, or from a strong workplace culture that fosters higher rates of employee retention and CEO approval.

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How does your corporate lifecycle diversification impact the ESG analysis?

Alaina: As I noted previously, we don't apply minimum ESG scoring criteria to identify Leaders because there can be important nuances to consider, including those related to corporate lifecycle.

For example, from a corporate governance perspective, we recognize that smaller-cap, emergent growth companies may have less mature board structures and practices than larger-cap, expanding and sustained growth companies.

In addition to lifecycle stage, it's important to consider where the company is domiciled and listed, as governance codes and listing requirements vary significantly across geographies.

Can you tell us why you got into the investment business?

Alaina: I started an investment club with my friends after graduating from college. It was around 2000, and it seemed like everyone was getting dot-com jobs and dipping into the market. My dad was really into the MacNeil/Lehrer Report, so while I didn't have any direct experience investing in stocks, I had some perspective on the stock market and how to build wealth.

At what point did you decide to turn investing into a career?

Alaina: At the same time I had the investment club, I was working in consulting, and one of my engagements was trying to understand why a client's 401(k) plan had low usage. We had to demonstrate the time value of money to employees at this company—basically, talking about the math of how money grows, why you should be investing, and what the lost opportunity is for not doing it. I was really enjoying all of it and realized investing was what I wanted to do as a full-time job. Not long after that I left consulting for a job at what was then Paine Webber. I realized I had a true passion for investing and wanted to stay in the field.

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About William Blair
William Blair is committed to building enduring relationships with our clients and providing expertise and solutions to meet their evolving needs. We work closely with most sophisticated investors globally across institutional and intermediary channels. We are 100% active-employee-owned with broad-based ownership. Our investment teams are solely focused on active management and employ disciplined, analytical research processes across a wide range of strategies. As of December 31, 2020, we manage $69.7 billion in assets. We are based in Chicago with resources in New York, London, Zurich, Sydney, Stockholm, and The Hague, and dedicated coverage for Canada.