Market Efficiency Hypothesis

Topics to be Discussed

Evaluation of Technical and Fundamental Analysis
Weak market efficiency hypothesis
Semistrong market efficiency hypothesis
Strong market efficiency hypothesis
Requirements for an efficient market

Evaluation of Technical and Fundamental Analysis

Usefulness of technical and fundamental approaches depend on efficiency of market

- ☛ market efficiency concerned with how well the financial markets channel resources to most efficient users
- ☛ market efficiency concerned with how well the market allows its participants to correctly gauge the actual and expected performance of a business entity

Market Efficiency Hypotheses

Weak efficiency market hypothesis

- ☛ can't look at patterns of the past prices and deduce anything about future prices (random walk hypothesis)
  - analyzing past data does not permit the technician to forecast the movement of prices about the trend line
  - new information affecting stock prices enters the market in random fashion
  - a direct challenge to the chartist or technician
- ☛ various studies have concluded stock prices move in random fashion
  - not all statistical studies have supported the random walk theory
  - there are objections to the way the research is conducted
  - some involved with technical analysis claim, on basis of their observation, that random walk hypothesis is not valid

Semistrong efficient market hypothesis

- ☛ can't make money (predict future prices) based on past price patterns or on any <u>public</u> information
  - assumed market prices instantaneously reflect all publicly known information
  - measures the ability of the market to anticipate new information and the speed with which it adjusts to such data
  - a direct challenge to fundamental financial analysis based on evaluation of publicly available data

Strong efficient market hypothesis

- ☛ not only are past price patterns and public information irrelevant, but all information, including inside information, is irrelevant in predicting future stock prices

Requirements for an efficient market

Effective information flow
- ☛ Amex Stockwatch

Fully rational investors
- ☛ rational beliefs regarding future returns and risks
- ☛ rational choice -- attitude of risk aversion
- ☛ willingness and ability to act upon personal assessments of the situation

Rapid price change to new information

Low transaction cost

Continuous trading

Conclusion

- ☛ It would appear logical that investor strategies, market involvement, and requirements for funds might lead to a less than perfectly efficient market. The more informed, more active investors would be expected to act faster than the less informed, less active investor

- ☛ It is possible, maybe likely, that a combination of technical approach and fundamental approach could, if conducted on a timely basis, produce results that would be better than the average market performance