

Efficient market hypothesis

[Finance](#), [Market](#)



Efficient market hypothesis is one of the most important concepts in the science and art of investment management as it provides a deeper insight into how the markets respond to the external as well as internal information and as a result how the prices shall actually behave while incorporating this information. It has also been argued that the efficient market hypothesis fails to integrate the behavioral and psychological aspects of the stock price movements and as such may not prove as an empirically valid theoretical construct.

However, despite such arguments, it is considered as one of the most important contributions ever made to the finance. Market efficiency is considered as the ability of the markets to fully integrate the currently publically available information into the market prices and as such basic idea is how quickly competition force to drive all the information to be reflected into the market prices. (han, 2009). It is also determined as the inability of the market participants to outweigh the market by trading based on the information available to all market participants.

According to this postulates, investors therefore can not earn abnormal economic profits and as such under perfect market conditions, all market participants only earn normal profits. The fundamental assumptions behind the efficient market hypothesis were based on the fact that the financial markets are extremely efficient because it was generally believed that the investors have put in place an in-built mechanism which allowed them to automatically integrate the publically available information into the prices and market itself therefore discount such information into the prices of the stocks.

The basic idea therefore was that since the stock prices follow the random walk therefore today's prices will reflect the information available today and tomorrow's information will be reflected in the prices of tomorrow. According to the efficient market hypothesis, there are three types of efficiencies reflected by the market and studies on the major developed markets indicate that these markets are semi- strong efficient in nature. The three types of efficiencies include weak form of efficiency, semi strong efficiency and strong efficiency.

In a weak form of efficiency, share prices reflect all the publically available information that has been contained in the past price movements and as such it technical analysis will be of no use to the investors. Weak form of efficiency also outline that the investors can predict the price movements based on the past variations in the past thus all the efforts to read between the lines of price movements of yesterday would hardly affect any price movements of today.

In semi- strong market efficiency, the stock prices also reflect all the publically available information including any announcements of the dividends as well as other information. This therefore also means that the fundamental analysis will be of no use and investors will not be able to gain any insight into how the future prices will behave. (Malkiel, 2003). Semi- strong form of efficiency is also important in the sense that most of the investors tend to predict the future behavior of the market prices based on the fundamentals of the company thus attempt to exploit the opportunities available for very short period of time i.

e. the time lag between the release of information and its discounting into the stock prices. Investors, in this form of efficiency can take advantage of arbitrage pricing also because it is often believed that the prices tend to move into an arbitrage band therefore if investors have the ability to spot that arbitrage band than there are chances that the investors may be able to earn abnormal profits under this form of efficiency.

Finally, the strong form of efficiency indicates that all the information whether publically available or private information is fully integrated into the stock prices and as such investors can only gain abnormal economic profits if they have the insider information which is not available to others. In this form of efficiency, investors therefore can take benefit if they have the insider information. The subsequent empirical studies performed on major markets suggested variable results as some markets indicated strong form of efficiency and others showed weak or semi- strong form of efficiency.

One study performed on sixteen developed and four emerging markets indicated that the market efficiency in countries like UK and Germany is complying with the most stringent random walk criteria and hence are considered as the strong form of market efficiency. Further, it has also been empirically validated that most of the IPOs tend to be underpriced no matter what form of market efficiency is existing in any given market. Given this, it is however, also collectively believed that markets are basically inefficient and offer opportunities to the market participants to take advantage of such opportunities.

(Kaen, 2003). Reference list 1. Malkiel, Burton G. (2003). The Efficient Market Hypothesis and Its Critics [online]. [Accessed 1st May 2009]. Available from <https://assignbuster.com/efficient-market-hypothesis/>

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