Example of essay on efficient capital market

Business, Marketing

Capital markets are markets in which institutions and individuals buy and sell financial securities. Capital markets channel funds from wealth savers institutions that need funds for long term investments. Capital markets comprise of both the equity and debt markets. Investors participate in the capital market in order to maximize their wealth by buying, holding and selling financial securities in order to take advantage of price fluctuations in the capital market. There are various theories that have been developed to explain the performance of investors' portfolio. One of the dominant theories is the efficient market hypothesis. This paper discusses the efficient market hypothesis. To this end, this paper will use the efficient capital hypothesis to explain whether it is possible to beat the market, its implication in valuing financial securities, and evaluate evidence on asset pricing modification model.

Efficient market hypothesis is a theory in investment that states that the efficiency of the stock market leads to the incorporation of existing share prices hence; the stock market prices reflect relevant and correct information. This theory is based on three assumptions; there are no taxes and transaction fees, information is randomly and freely available, and that investors are rational, independent and informed. Based on the efficient market hypothesis, stocks always trade on stock exchanges at their fair values. This makes it almost impossible for investors to sell inflated priced stocks or buy undervalued stocks. Therefore, no investor can outperform the stock market using expert selection of stocks or market timing. The hypothesis also states that the best way for an investor to realize high returns is to buy risky investments. Therefore, an efficient capital market is

one where investors cannot beat the market in any way because all stocks are sold and bought at their fair value.

Using the efficient capital market hypothesis, market efficiency can be explained in three ways. These are allocative efficiency, operational efficiency and informational efficiency. Allocative efficiency is realized when the market channels its savings towards productive efficient projects or enterprises. In such a situation, enterprises can easily raise finances. To achieve optimal allocative efficiency, there must be no alternative channeling or allocating of money from savings that can lead to greater economic prosperity. In allocative efficiency, financial disintegration should be nurtured. Another way of explaining capital market efficiency is through the use of operational efficiency. This concept involves costs incurred to borrow money for the borrower and the cost of lending for the lender in a given capital market. If the cost of transaction is high, the cost of using that financial market will be high.

Finally, informational efficiency is the third kind of efficient capital markets. It shows how the information on the future of a security affects the security's current price. Both public and inside information is reflected in the security's price. Given this condition, investing in stocks is a fair game because every investor has equal chances. This is because information is reflected in the share price. Information efficiency is essential because management decisions in financial management are accurately and quickly reflected in security prices. The efficient market hypothesis is directly affected by information efficiency. An efficient stock market is one where share prices reflect all information accurately. Therefore, are no chances that shares in

the market will be undervalued or overvalued. Therefore, an investor cannot beat the market by purchasing undervalued shares or selling shares that are overvalued.

There are several implications of valuing securities in capital markets. These implications affect investors, decision makers such as financial managers and the market as a whole. Efficient market hypothesis can affect the financial policy's timing. Financial managers believe that shares cannot be issued anyhow at any given time. New shares in an initial public offer can only be issued at a time when the market is on a high rather than when it is low. In an efficient market, however, share prices do not follow a distinct trend that managers can follow closely. Therefore, financial managers are unable to determine whether the prevailing prices are the lowest or the highest. Even though, other policies such as the stock split announcements and financial statement release have no impact of share prices, the financial policy affects the valuation of securities in any capital market.

Efficient market hypothesis also affects stock valuations through creative accounting. Usually, prices are set based on the expected cash flows in future. Therefore, the prices reflect all the available current information. This means that efficiency market hypothesis restricts firms from interfering with current information to take advantage of their investors. This is because investors will quickly detect such an attempt. Investors cannot be misled by a company's efforts to manipulate accounting information to show profits or to alter the capital structure of the company. The hypothesis ensures that investors know how the company's cash flows operate, and the implications of the cash flows hence; they will change their company's share prices.

Takeovers and mergers are also an implication of efficient market hypothesis. Given that shares are accurately priced, then the purchase of one’s share during takeovers and mergers is always zero in terms of NPV transactions. Market efficiency ensures that companies that are acquired at their accurate market prices lead to the investors breaking even. The acquirer of another company should not pay more than the company’s NPV. Contrary to this, the acquirer will have a negative NPV hence the investment will not reflect market efficiency.

Another implication is the prevailing market price validity. Efficient markets reflect all public information concerning investors and existing share prices. Therefore, investors are aware that if they buy shares at the prevailing prices, they are getting a good combination of risk and return. This implies that there is nothing like an overvalued or undervalued security. Firms are not supposed to be giving huge security discounts since investors do not require more incentives than they have to buy the shares.

The efficient market hypothesis is the evaluation of projects based on the NPV approach. Financial managers utilize the existing rate of return based on how shares are traded in the given capital market. One can obtain the rate of return of a given project by observing the rate of return needed by investors of companies investing in similar risk projects. This implies that shares are always priced fairly in relation to the risk they carry in case of a market efficient environment. Therefore, it is not possible for investors to outperform the market.

There is sufficient evidence in the consumption based assed pricing model in an attempt to give a comprehensive explanation to the anomalies in capital

markets. Portfolios of common stock in over 17 international markets operate on this principle. American government bonds, common stocks and corporate bonds also operate on that principle. In this model, the portfolio decisions and maximum consumption lead to a linear positive relation of expected returns on a share and its consumption. Therefore, this model can be summarized that every incentive to hedge consumption shifts and portfolio chances can be seen in a multifactor model that has a one factor between consumption and expected returns. Empirical work in the consumption based asset pricing model usually does a joint test of cross-section predictions and time series. Estimations are done using generalized methods (Fama, 1996). Information obtained from the tests of this model includes the unconditional tests results. This test concentrates on the model's prediction about the cross section of expected outcomes. It shows that the given consumer, whose preferences characterize the prices of the assets, should possess high risk aversion. This is meant to explain the huge spread of anticipated share returns over securities with low risks such as treasury bills. These assumptions in the model are usually modified to contain large equity premiums. This is why premium is always consistent with models where utility is dependent on past consumption. The argument of habit formation is true, although huge equity premium is not a puzzle. The large premium implies that consumers are very averse to tiny negative consumption shocks. This is along the perception that consumers fear recessions. The equity premium puzzle is a prominent feature of unconditional tests since it focuses on the expected returns' properties. From the tests, approximations of risk aversion are not precise. There are

reasonable approximations of risk aversion for the given consumer.

In conclusion, if the assumptions of an efficient market hypothesis hold; investors cannot outperform the market. This is because stocks always trade on stock exchanges at their fair values. The fair value of stock reflects its risk, return and any other public and inside information. This makes it difficult for investors to sell inflated priced stocks or buy undervalued stocks. Therefore, no investor can beat the stock market using expert selection of stocks or market timing. The best way for an investor to realize high returns is to buy risky investments. A few cases of investors who outperform the market are random and arbitrary which does not invalidate the efficient market hypothesis.

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