Efficient market hypothesis and financial crisis

The well-known efficient market hypothesis is published by Eugene Fama in the 20 th century. Even though it has many useful applications up to now, this theory is suspected for causing the global financial crisis.

According to the efficient market hypothesis, efficient market is the place where the price of the stock will quickly adjust when new information appears therefore a current price of any securities reflect all information relating to it in the market.

Consequently, no one can earn profits through old information or the fluctuations of price in the past. Thus investors cannot outsmart the market. The concept of efficiency is used to imply the quick absorption of information, not the resources to create maximum output as in other fields of economics. Information is also understood that the news might affect the price and unpredictable.

The majority of previous studies on efficient markets is based on " random walk hypothesis", it refers to the random change in stock prices. Those academic research were full of empirical analysis, which did not follow a theory. In 1970, Fama tried to formalize and streamline hypothesis according to the empirical evidences at that time. Fama who presented the theory of efficient markets model in terms of a fair game, confirmed that investors may believe that the current price of a stock reflects all available information about securities, and profit expectations based on the price and its risks. In his initial report, Fama separated efficient market hypothesis and its testing into three smaller hypotheses based on the information including: Weak-form efficiency, Semi-strong-form efficiency, Strong-form efficiency.

Weak-form efficiency admits weak current stock prices fully reflect all market information, including the sequence of past prices, income rate , trading volume , and other information general information concerning the transaction market such as small and large batch transactions , and transactions of foreign currency trading experts because it recognizes that current prices reflect all real information in the past and other market information . This hypothesis implies that the ratio of income and market data in the past does not have relations with the rate of return in the future. Therefore, the investors should not worry too much when using the principle of transactions based on rate of return and other data of the market in the past.

Semi-strong-form efficiency asserts that stock prices adjust quickly to any information that was public, it can be said that the current price fully reflects all publicly available information. This hypothesis covers the weak-form efficiency, because all published information on the market are examined publicly such as stock prices, fertility rates, trading volume. The public information also includes non-market information such as notification and dividend earnings, book value, political news. Semi-strong-form efficiency is significant decisions of investors based on important new information after it announced because stock prices reflect all available information.

Strong-form efficiency believes that stock prices fully reflect all information from public to internal. This means that no investor can access exclusively to information in order to impact the price. Moreover, this theory asserts the recognition of the efficient market in which prices adjust quickly to new information, has assumed the perfect market in which all information is free and available to everyone at the same time.

It is important to understand why markets should be efficient, effective market gives benefit to the financial markets in particular and the whole economy in general. Many research indicates that an efficient market can bring many advantages for the economy. Frist, encouraging investors' confidence in the market and so they will pour capital into the market without wasting resources. Investors always think that their investment is the opportunity to choose freely for themselves and do not worry that they will have to face with uncontrollable risk at any time. Furthermore, effective distribution will be boosted, in an efficient market, capital will seek to get the businesses that have real economic effects. In addition, the improvement of market information will lead to the rise in investment opportunities. In an efficient market, information is reflected correctly and quickly in prices. Efficient markets are also showing the market information is the reliable information then it will become attractive channel for the investments.

Although the EMH still has many mistakes, mostly because of its assumptions. First, the EMH assumes that all investors are aware of all the information available on the market in an identical manner. However, there are many methods to analyze and evaluate various stocks which raise a range of issues about the correctness of the assumption of efficient markets hypothesis. If investors looking for investment opportunities which are undervalued while the other investors evaluate a stock based on its growth potential, then there is no doubt that those two investors will have two completely different conclusions about the fair market value of a stock .

Thus, an argument which rejected the viewpoint of EMH indicates that the evaluations of investors about stocks are different so it is impossible to evaluate the price of a stock in efficient market.

Secondly, according to the EMH, not a single investor can gain higher returns than other person with the same amount of investment, the balance property of their information means that they can only be obtained the identical gains. But let’s review a series of very different profits that investors, hedge funds are earned. If an investor does not have any advantages than others, then why the statistics show that some mutual funds have serious loss and some mutual funds can gain significant profit. According to EMH, the profitable investment of an investor will lead to the benefit for all investors in the whole world . In fact, this cannot be true. Furthermore, no investor can outsmart the market and surpass the annual average level of profitability that all investors and investment funds achieved. But in reality, there is always a series of examples of investors who can beat the market. For instance, Warren Buffett is the most typical example of many successful investments.

Finally, the efficient market hypothesis proved it correctness for a few types of private securities, not quite right with the whole market. Sometimes there are fluctuations on the stock market, and many economists said that it was the result of the general psychology of the investors and not influenced by the available and public information.

After the global financial crisis, it is clearly seen that there are many criticisms against EMH, but the truth is quite the opposite.

Most of the people do not understand clearly about this theory, thus this lead to the first problem: the misinterpretation of the theory. EMH claimed that price reflected all the information so no investors should create abnormal profit. But it did not mean that the abnormal profit is totally impossible. It is just the average investors are not expected to make abnormal profit, but some investors may let the price into the fluctuation in order to gain profit. Moreover, the refection of price about all the information lead to another misunderstanding that the price can help the investors foresee the crisis. Through the Random Walk hypothesis , we can see that the EMH cannot predict the crisis . The EMH never point out that it can forecast exactly the time when crisis happens. Additionally, people may think the fall of large institutions cause the inefficient of the market. Obviously , it is not the fact according to the Random Walk hypothesis , no one can be guaranteed from abnormal profit , everyone may collapse at any time even though how big or magnificent it is .

The final problem is the misjudgments of the theory. At first, many regulators laid the blame at EMH instead of themselves. They said that they have to deal with the financial crisis because they have confidence at EMH. But if they really do believe in EMH, they have to know about the abnormal sights from risk-takers such as Lehman brothers, Fannie May and Freddie Mac and so on. They should look closer into their possible frauds and faults but they did not . Therefore it is not likely they trusted in EMH, yet they did not have enough faith in it. EMH is just a theory, and it still has many limitations. What we should do is revolve and apply flexibility this theory in the moving world, not put all the blame on it.

To sum up, although EMH has some certain limitation, it is still essential for all markets and investors. Additionally, EMH has come under many heavy criticisms as if it is the main reason of the Global financial crisis. But personally, I think EMH did not take the responsibility for the Global financial crisis.