EFFICIENT MARKET

An efficient market is one where the market price is an unbiased estimate of the true value of the investment.

Market efficiency does not require that the market price be equal to true value at every point in time. All it requires is that errors in the market price be unbiased, i.e., that prices can be greater than or less than true value, as long as these deviations are random.

EFFICIENT MARKET HYPOTHESIS

It was proposed by Eugene Fama in 1960s. The efficient market hypothesis states that at any given time and in a liquid market, security prices fully reflect all available information. The EMH exists in various degrees: weak, semi-strong and strong, which addresses the inclusion of non-public information in market prices. This theory contends that since markets are efficient and current prices reflect all information, attempts to outperform the market are essentially a game of chance rather than one of skill.

Degrees of Efficient Market

The **weak form** of EMH assumes that current stock prices fully reflect all currently available security market information. It contends that past price and volume data have no relationship with the future direction of security prices. In other words, the current price reflects the information contained in all past prices, suggesting that charts and technical analyses that use past prices alone would not be useful in finding under-valued stocks. It concludes that excess returns cannot be achieved using technical analysis.

The **semi-strong form** of EMH assumes that current stock prices adjust rapidly to the release of all new public information. It contends that security prices have factored in available market and non-market public information. In other words, the current price reflects the information contained not only in past prices but all public information (including financial statements and news reports) and no approach that was predicated on using and massaging this information would be useful in finding under-valued stocks. It concludes that excess returns cannot be achieved using fundamental analysis and technical analysis.

The **strong form** of EMH assumes that current stock prices fully reflect all public and private information. It contends that market, non-market and inside information is all factored into security prices and that no one has monopolistic access to relevant information. In other words, the current price reflects all information, public as well as private, and no investors will be able to consistently find under-valued stocks. It assumes a perfect market and concludes that excess returns are impossible to achieve consistently.

<u>Implications of market efficiency</u>

An immediate and direct implication of an efficient market is that no group of investors should be able to consistently beat the market using a common investment strategy. An efficient market would also carry very negative implications for many investment strategies and actions that are taken for granted -

(a) In an efficient market, equity research and valuation would be a costly task that provided no benefits. The odds of finding an undervalued stock would always be 50:50, reflecting the randomness of pricing errors. At best, the benefits from information collection and equity research would cover the costs of doing the research.

(b) In an efficient market, a strategy of randomly diversifying across stocks or indexing to the market, carrying little or no information cost and minimal execution costs, would be superior to any other strategy, which created larger information and execution costs. There would be no value added by portfolio managers and investment strategists.

(c) In an efficient market, a strategy of minimizing trading, i.e., creating a portfolio and not trading unless cash was needed, would be superior to a strategy that required frequent trading.

It is therefore no wonder that the concept of market efficiency evokes such strong reactions on the part of portfolio managers and analysts, who view it, quite rightly, as a challenge to their existence.

It is also important that there be clarity about what market efficiency does not imply.

An efficient market does not imply that -

(a) Stock prices cannot deviate from true value; in fact, there can be large deviations from true value. The only requirement is that the deviations be random.

(b) No investor will 'beat' the market in any time period. To the contrary, approximately half of all investors, prior to transactions costs, should beat the market in any period.

(c) No group of investors will beat the market in the long term. Given the number of investors in financial markets, the laws of probability would suggest that a fairly large number are going to beat the market consistently over long periods, not because of their investment strategies but because they are lucky. It would not, however, be consistent if a disproportionately large number3 of these investors used the same investment strategy.

In an efficient market, the expected returns from any investment will be consistent with the risk of that investment over the long term, though there may be deviations from these expected returns in the short term.