CHAPTER 35

MARKET EFFICIENCY

1. (B) **Spend more time working on security selection.**

Explanation

In an efficient market all stocks are properly priced and reflect all publicly available information. Therefore, individual selection of stocks is not important the only thing that is relevant is the portfolio's beta.

(Study Session 11, Module 35.1, LOS 35.e)

Related Material

SchweserNotes - Book 3

2. (B) **Both weak form and semistrong form.**

Explanation

The momentum effect suggests it is possible to earn abnormal returns using market data. All three forms of market efficiency (weak form, semistrong form, and strong form) assume that market prices fully reflect market data.

(Study Session 11, Module 35.1, LOS 35.f)

Related Material

SchweserNotes - Book 3

3. (A) **Strong-form.**

Explanation

According to the strong-form EMH, security prices reflect all information, which includes the privately available (monopolistic) information.

(Study Session 11, Module 35.1, LOS 35.d)

Related Material

SchweserNotes - Book 3

4. (A) **investors cannot achieve abnormal returns, on average, using technical analysis, after adjusting for transaction costs and taxes.**

Explanation

The weak form of the EMH implies that an investor cannot earn positive abnormal returns on average using technical analysis (market information), after adjusting for transaction costs and taxes. Evidence has shown that insiders can achieve positive abnormal returns on average, but this relates to the strong form of the EMH.

For Further Reference:

(Study Session 11, Module 35.1, LOS 35.e)

CFA® Program Curriculum, Volume 4, page 249

Related Material

SchweserNotes - Book 3

5. (B) **Number of participants.**

Explanation

As the number of market participants increases, the speed at which markets adjust to new information is likely to increase. Restrictions on short selling limit the ability of arbitrage to correct pricing anomalies. High bid-ask spreads increase transaction costs and decrease efficiency.

(Study Session 11, Module 35.1, LOS 35.c)

Related Material

SchweserNotes - Book 3

6. (B) **Low P/E stocks tend to have positive abnormal returns over the long run.**

Explanation

P/E information is publicly available information and therefore this test relates to the semi-strong form EMH. Trend analysis is based on historical information and therefore relates to the weak-form EMH. In an efficient market one would expect 50% of pension fund managers to do better than average and 50% of pension fund managers to do worse than average. If all investors exploit the same information no excess returns are possible.

(Study Session 11, Module 35.1, LOS 35.f)

Related Material

SchweserNotes - Book 3

7. (B) **publicly available information.**

Explanation

The semi-strong form of the EMH asserts that security prices fully reflect all publicly available information. This includes all historical price and volume information, which the weak form of the EMH asserts is fully reflected in security prices. The strong form of the EMH asserts that security prices fully reflect all public and private information.

(Study Session 11, Module 35.1, LOS 35.d)

Related Material

SchweserNotes - Book 3

8. (A) a ban on short selling.

Explanation

Short selling helps to prevent market prices from becoming overvalued, while limiting short selling has the opposite effect. More analyst coverage and more liquidity (high trading volume) contribute to market efficiency.

(Study Session 11, Module 35.1, LOS 35.c)

Related Material

SchweserNotes - Book 3

9. (A) all public information is already reflected in security prices.

Explanation

Semi-strong EMH states that publicly available information cannot be used to consistently beat the market performance.

(Study Session 11, Module 35.1, LOS 35.d)

Related Material

SchweserNotes - Book 3

10. (A) Processing new information entails costs and takes at least some time, so security prices are not always immediately affected.

Explanation

If market prices are efficient there are no returns to the time and effort spent on fundamental analysis. But if no time and effort is spent on fundamental analysis there is no process for making market prices efficient. To resolve this apparent conundrum one can look to the time lag between the release of new value-relevant information and the adjustment of market prices to their new efficient levels. Processing new information entails costs and takes at least some time, which is a limitation of fully efficient markets.

(Study Session 11, Module 35.1, Los 35.e).

Related Material

SchweserNotes - Book 3

11. (B) information cascades.

Explanation

"Information cascades" refers to uninformed traders watching the actions of informed traders when making investment decisions. Herding behavior is when trading occurs in clusters, not necessarily driven by information. Narrow framing refers to investors viewing events in isolation.

(Study Session 11, Module 35.1, LOS 35.g)

Related Material

SchweserNotes - Book 3

12. (C) **The gains to be earned by information trading can be less than the transaction costs the trading would entail.**

Explanation

Market prices that are not precisely efficient can persist if the gains to be made by information trading are less than the transaction costs such trading would entail.

(Study Session 11, Module 35.1, LOS 35.e)

Related Material

SchweserNotes - Book 3

13. (C) **market value.**

Explanation

The current price of a traded asset is its market value. An asset's intrinsic or fundamental value is the price a rational investor with complete information about the asset would pay for it.

(Study Session 11, Module 35.1, LOS 35.b)

Related Material

SchweserNotes - Book 3

14. (A) **fully reflects all of the information currently available about a given security, including risk.**

Explanation

An efficient capital market fully reflects all of the information currently available about a given security, including risk.

(Study Session 11, Module 35.1, LOS 35.a)

Related Material

SchweserNotes - Book 3

15. (C) **Semistrong and strong forms only.**

Explanation

The semi-strong form of EMH states that security prices rapidly adjust to reflect all publicly available information. If the analyst can use his model, which is based on publicly available information, to earn above average returns, the semi-strong form of the EMH has been violated. If the semi-strong form of EMH is violated, the strong form of EMH is also violated.

For Further Reference:

(Study Session 11, Module 35.1, LOS 35.e)

CFA® Program Curriculum, Volume 4, page 244

CFA® Program Curriculum, Volume 4, page 249

Related Material

SchweserNotes - Book 3

16. (C) **remain the same.**

Explanation

An efficient capital market would price Hume's stock based on the expectation for earnings per share. Since actual earnings equal expected earnings, the stock price should not change as a result of the announcement.

(Study Session 11, Module 35.1, LOS 35.a)

Related Material

SchweserNotes - Book 3

17. (C) **Low returns over a three-year period are followed by high returns over the following three years.**

Explanation

The overreaction effect refers to stocks with poor returns over three to five-year periods that had higher subsequent performance than stocks with high returns in the prior period. The result is attributed to overreaction in stock prices that reverses over longer periods of time. Stocks with high previous short-term returns that have high subsequent returns show a momentum effect.

(Study Session 11, Module 35.1, LOS 35.f)

Related Material

SchweserNotes - Book 3

18. (A) **achieve complete diversification of the portfolio.**

Explanation

In an efficient market, portfolio managers must create and maintain the appropriate mix of assets to meet their client's needs. The portfolio should be diversified to eliminate unsystematic risk. The appropriate systematic risk will depend on the clients risk tolerance and return requirement. Over time the needs of the client and environment will justify changes to the portfolio. The manager should also try to minimize transaction costs and at least try to match the performance of a benchmark.

(Study Session 11, Module 35.1, LOS 35.e)

Related Material

SchweserNotes - Book 3

19. (C) **The weak-form EMH assumes market prices reflect current public market information and expectations.**

Explanation

The weak-form EMH assumes the price of a security reflects all historical price and volume information.

The other statements are true. The semi-strong form EMH assumes market prices reflect all public information. The strong-form EMH states that stock prices reflect all types of information: market, non-public market, and private.

(Study Session 11, Module 35.1, LOS 35.d)

Related Material

SchweserNotes - Book 3

20. (C) analyzing financial statements to select undervalued stocks.

Explanation

Semi-strong form market efficiency implies that fundamental analysis of publicly available information will not generate abnormal returns on average. Portfolio managers should help quantify a client's risk tolerances and return needs, offer portfolio policies and strategies to meet these needs, and construct a portfolio by allocating funds to appropriate asset classes. Portfolio managers can also create value by diversifying their clients' portfolios globally to reduce risk, monitoring and evaluating changing capital market conditions, monitoring their clients' needs and circumstances, and rebalancing their clients' portfolios when necessary.

For Further Reference:

(Study Session 11, Module 35.1, LOS 35.e)

CFA® Program Curriculum, Volume 4, page 249

Related Material

SchweserNotes - Book 3

21. (A) less than its intrinsic value.

Explanation

A security with a market price less than its intrinsic value is undervalued.

(Study Session 11, Module 35.1, LOS 35.b)

Related Material

SchweserNotes - Book 3

22. (B) Public and private.

Explanation

The strong-form EMH assumes that stock prices fully reflect all information from public and private sources.

(Study Session 11, Module 35.1, LOS 35.d)

Related Material

SchweserNotes - Book 3

23. (A) **diversify to eliminate systematic risk.**

Explanation

Portfolio managers cannot eliminate systematic risk (i.e., market risk) thru the use of diversification. Portfolio managers should try to eliminate unsystematic portfolio risk.

(Study Session 11, Module 35.1, LOS 35.e)

Related Material

SchweserNotes - Book 3

24. (B) **loss aversion.**

Explanation

Loss aversion refers to the tendency for investors to dislike downside risks more than upside risks creating asymmetrical risk preferences. This dislike of losses may be a cause of investor overreaction. The standard economic notion of risk aversion assumes symmetric risk preferences. Conservatism is the behavioral bias whereby investors react slowly to new information and is unlikely to cause overreaction.

(Study Session 11, Module 35.1, LOS 35.g)

Related Material

SchweserNotes - Book 3

25. (B) **dislike losses more than they like gains.**

Explanation

Behavioral finance proposes that investors are loss averse. Loss aversion means investors dislike losses more than they like gains of the same amount.

(Study Session 11, Module 35.1, LOS 35.g)

Related Material

SchweserNotes - Book 3

26. (A) **quantify client's risk tolerance, communicate portfolio policies and strategies, and maintain a strict buy and hold policy avoiding any changes in the portfolio to minimize transaction costs.**

Explanation

A portfolio manager should quantify each client's risk tolerance and communicate portfolio policies and strategies. However, portfolio managers should monitor client's needs and changing circumstances and make appropriate changes to the portfolio. Adhering to a strict buy and hold policy would not be in the client's best interest. Portfolios need to be rebalanced and changed to meet client's changing needs.

(Study Session 11, Module 35.1, LOS 35.e)

Related Material

SchweserNotes - Book 3

27. (B) **Market efficiency assumes that individual market participants correctly estimate asset prices.**

Explanation

Market efficiency does not assume that individual market participants correctly estimate asset prices, but does assume that their estimates are unbiased. That is, some agents will over-estimate and some will under-estimate, but they will be correct, on average.

(Study Session 11, Module 35.1, LOS 35.e)

Related Material

SchweserNotes - Book 3

28. (B) **Loss aversion.**

Explanation

Loss aversion is exhibited by an investor who dislikes a loss more than he likes an equal gain. That is, the investor's risk preferences are asymmetric. Mental accounting refers to mentally classifying investments in separate accounts rather than considering them from a portfolio perspective. In behavioral finance, conservatism refers to a tendency to maintain one's prior views even in the presence of new information.

(Study Session 11, Module 35.1, LOS 35.g)

Related Material

SchweserNotes - Book 3

29. (A) **mimic the actions of better-informed investors.**

Explanation

Mimicking the actions of better-informed investors is an example of herding behavior. Behavioral finance suggests investors are more risk averse with respect to losses than gains and tend to overestimate their ability to analyze security information.

For Further Reference:

(Study Session 11, Module 35.1, LOS 35.g)

CFA® Program Curriculum, Volume 4, page 257

Related Material

SchweserNotes - Book 3

30. (C) **passive portfolio management strategies.**

Explanation

If the market is semi-strong efficient, portfolio managers should use passive management because neither technical analysis nor fundamental analysis will generate positive abnormal returns on average overtime.

(Study Session 11, Module 35.1, LOS 35.e)

Related Material

SchweserNotes - Book 3

31. (A) buying and holding a broad market portfolio is the preferred investment strategy.

Explanation

If financial markets are informationally efficient, active investment strategies cannot consistently achieve risk-adjusted returns superior to holding a passively managed index portfolio. In addition, a passive investment strategy has lower transactions costs than an active management strategy. Share prices should not adjust when a company announces results in line with expectations in an informationally efficient market, because the market price already reflects the expected results.

(Study Session 11, Module 35.1, LOS 35.a)

Related Material

SchweserNotes - Book 3

32. (C) January anomaly.

Explanation

The January Anomaly is most likely the result of tax induced trading at year end. An investor can profit by buying stocks in December and selling them during the first week in January.

(Study Session 11, Module 35.1, LOS 35.f)

Related Material

SchweserNotes - Book 3

33. (A) Price adjustments are biased.

Explanation

Market efficiency assumes that investors adjust their estimates of security prices rapidly to reflect their unbiased interpretation of the new information. New information arrives randomly and independently. Therefore, price changes are independent.

(Study Session 11, Module 35.1, LOS 35.c)

Related Material

SchweserNotes - Book 3

34. (A) Strong-form EMH.

Explanation

This is the definition of the strong-form EMH. Private sources include insider information, such as persons holding monopolistic access to information relevant to the formation of prices.

(Study Session 11, Module 35.1, LOS 35.d)

Related Material

SchweserNotes - Book 3

35. (A) intrinsic value.

Explanation

Intrinsic value is the price a rational investor with full knowledge about an asset's characteristics would willingly pay for the asset.

(Study Session 11, Module 35.1, LOS 35.b)

Related Material

SchweserNotes - Book 3

36. (C) Strong-form.

Explanation

The strong-form EMH assumes that stock prices fully reflect all information from public and private sources. In addition, no group of investors has monopolistic access to information relevant to the formation of prices.

(Study Session 11, Module 35.1, LOS 35.d)

Related Material

SchweserNotes - Book 3