35 MARKET EFFICIENCY

1. If the efficient markets hypothesis is true, portfolio managers should do all of the following EXCEPT:
   (A) Minimize transaction costs.
   (B) Spend more time working on security selection.
   (C) Work more with clients to better quantify their risk preferences.

2. If the momentum effect persists over time, it would provide evidence against which of the following forms of market efficiency?
   (A) Weak form only.
   (B) Both weak form and semistrong form.
   (C) Semistrong form only.

3. Which of the following forms of the EMH assumes that no group of investors has monopolistic access to relevant information?
   (A) Strong-form.
   (B) Both weak and semi-strong form.
   (C) Weak-form.

4. The weak form of the efficient market hypothesis (EMH) implies that:
   (A) investors cannot achieve abnormal returns, on average, using technical analysis, after adjusting for transaction costs and taxes.
   (B) no one can achieve abnormal returns using market information.
   (C) insiders, such as specialists and corporate board members, cannot achieve abnormal returns on average.

5. An increase in which of the following factors would most likely improve a market's efficiency?
   (A) Restrictions on short selling.
   (B) Number of participants.
   (C) Bid-ask spreads.

6. Which of the following would provide evidence against the semi-strong form of the efficient market theory?
   (A) All investors have learned to exploit signals related to future performance.
   (B) Low P/E stocks tend to have positive abnormal returns over the long run.
   (C) Trend analysis is worthless in determining stock prices.

7. The semi-strong form of the efficient market hypothesis (EMH) is most accurately described as asserting that security prices fully reflect all:
   (A) historical price and volume information.
   (B) publicly available information.
   (C) relevant information, including information not publicly available.

8. A market's efficiency is most likely to decrease by:
   (A) a ban on short selling.
   (B) substantial analyst coverage of exchange-listed companies
   (C) high volumes of trading activity.

9. The semi-strong form of efficient market hypothesis (EMH) asserts that:
   (A) all public information is already reflected in security prices.
   (B) both public and private information is already incorporated into security prices.
   (C) only past market information is reflected in security prices.

10. David Farrington is an analyst at Farrington Capital Management. He is aware that many people believe that the capital markets are fully efficient. However, he is not convinced and would like to disprove this claim. Which of the following statements would support Farrington in his effort to demonstrate the limitations to fully efficient markets?
   (A) Processing new information entails costs and takes at least some time, so security prices are not always immediately affected.
   (B) Stock prices adjust to their new efficient levels within hours of the release of new information.
   (C) Technical analysis has been rendered useless by many academics who have shown that analyzing market trends, past volume and trading data will not lead to abnormal returns.

11. The idea that uninformed traders, when faced with unclear information, observe the actions of informed traders to make decisions, is referred to as:
   (A) herding behavior.
   (B) information cascades.
   (C) narrow framing.

12. Which of the following is a limitation to fully efficient markets?
    (A) Information is always quickly disseminated and fully embedded in a security's prices.
    (B) There are no limitations to fully efficient markets because the trading actions of fundamental and technical analysts are continuously keeping prices at their intrinsic value.
    (C) The gains to be earned by information trading can be less than the transaction costs the trading would entail.

13. The measure of an assets value that can most likely be determined without estimation is its:
    (A) fundamental value.
    (B) intrinsic value.
    (C) market value.

14. An efficient capital market:
    (A) fully reflects all of the information currently available about a given security, including risk.
    (B) fully reflects all of the information currently available about a given security, excluding risk.
    (C) does not fully reflect all of the information currently available about a given security, including risk.

15. An analyst with Guff man Investments has developed a stock selection model based on earnings announcements made by companies with high P/E stocks. The model predicts that investing in companies with P/E ratios twice that of their industry average that make positive earnings announcements will generate significant excess return. If the analyst has consistently made superior risk-adjusted returns using this strategy, which form of the efficient market hypothesis has been violated?
    (A) Strong, semi-strong, and weak forms.
    (B) Weak form only.
    (C) Semistrong and strong forms only.

16. Hume Inc. announces fourth quarter earnings per share of $1.20, which is 15% higher than last year. Hume's earnings are equal to the consensus analyst forecast for the quarter. Assuming markets are efficient, the announcement will most likely cause the price of Hume's stock to:
    (A) decrease.
    (B) increase.
    (C) remain the same.

17. Which of the following statements best describes the overreaction effect?
    (A) High returns over a one-year period are followed by high returns over the following year.
    (B) High returns over a one-year period are followed by low returns over the following three years.
    (C) Low returns over a three-year period are followed by high returns over the following three years.

18. Under the efficient market hypothesis (EMH), the major effort of the portfolio manager should
    (A) achieve complete diversification of the portfolio.
    (B) follow a strict buy and hold strategy.
    (C) minimize systematic risk in the portfolio.

19. Which of the following statements on the forms of the efficient market hypothesis (EMH) is least accurate?
    (A) The semi-strong form EMH assumes market prices reflect all public information.
    (B) The strong-form EMH assumes market prices reflect all public and private information.
    (C) The weak-form EMH assumes market prices reflect current public market information and expectations.

20. If stock markets are semi-strong-form efficient, a portfolio manager is least likely to create value for investors by:
    (A) allocating invested funds among asset classes.
    (B) monitoring clients' needs and circumstances.
    (C) analyzing financial statements to select undervalued stocks.

21. A stock is said to be undervalued if its market price is:
    (A) less than its intrinsic value.
    (B) greater than its intrinsic value.
    (C) less than its book value.

22. The strong-form efficient market hypothesis (EMH) asserts that stock prices fully reflect which of the following types of information?
    (A) Market.
    (B) Public and private.
    (C) Public, private, and future.

23. In a perfectly efficient market, portfolio managers should do all of the following EXCEPT:
    (A) diversify to eliminate systematic risk.
    (B) monitor their client's needs and circumstances.
    (C) quantify their risk and return needs within the bounds of the client's liquidity, income, time horizon, legal, and regulatory constraints.

24. Investor overreaction that has been documented in securities markets is most likely attributable to investors exhibiting:
   (A) conservatism.
   (B) loss aversion.
   (C) risk aversion.

25. In behavioral finance theory, loss aversion is most accurately defined as asserting that for gains and losses of equal amounts, investors:
   (A) dislike for losses and like for gains are proportionate.
   (B) dislike losses more than they like gains.
   (C) like gains more than they dislike losses.

26. Which of the following statements least likely describes the role of a portfolio manager in perfectly efficient markets? Portfolio managers should:
   (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.
   (B) construct a portfolio that includes financial and real assets.
   (C) construct diversified portfolios that include international securities to eliminate unsystematic risk.

27. Which of the following statement concerning market efficiency is least accurate?
   (A) If weak-form market efficiency holds, technical analysis cannot be used to earn abnormal returns over the long-run.
   (B) Market efficiency assumes that individual market participants correctly estimate asset prices.
   (C) Tests of the semi-strong form of the EMH require that security returns be risk-adjusted using a market model.

28. An investor who is more risk averse with respect to potential negative outcomes than potential positive outcomes most likely exhibits which behavioral finance characteristic?
   (A) Conservatism.
   (B) Loss aversion.
   (C) Mental accounting.

29. Behavioral finance theory suggests that investors tend to:
   (A) mimic the actions of better-informed investors.
   (B) underestimate their ability to analyze security information.
   (C) be more risk averse with respect to gains than with respect to losses.

30. Octagon Advisors believes that the market is semi-strong efficient. The firm's portfolio managers most likely will use:
    (A) active portfolio management strategies.
    (B) an enhanced indexing strategy that relies on trading patterns.
    (C) passive portfolio management strategies.

31. In an informationally efficient market:
    (A) buying and holding a broad market portfolio is the preferred investment strategy.
    (B) share prices adjust rapidly when companies announce results in line with expectations.
    (C) the conditions exist for active investment strategies to achieve superior risk-adjusted returns.

32. The opportunity to take advantage of the downward pressure on stock prices that result from end-of-the-year tax selling is known as the:
    (A) end-of-the-year effect.
    (B) end-of-the-year anomaly.
    (C) January anomaly.

33. Which of the following would be inconsistent with an efficient market?
    (A) Price adjustments are biased.
    (B) Price changes are independent.
    (C) Stock prices adjust rapidly to new information.

34. The statement, "Stock prices fully reflect all information from public and private sources," can be attributed to which form of the efficient market hypothesis (EMH)?
    (A) Strong-form EMH.
    (B) Weak-form EMH.
    (C) Semistrong-form EMH.

35. The value of an asset that a rational investor with full knowledge about the asset's characteristics would willingly pay is best described as the asset's:
    (A) intrinsic value.
    (B) market value.
    (C) theoretical value.

36. Which of the following forms of the EMH assumes that no group of investors has monopolistic access to relevant information?
    (A) Weak-form.
    (B) Both weak and semistrong form.
    (C) Strong-form.