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Contemporary Issues in Finance
Efficient Market Hypotheses

V/O:
What do we mean by the term 'efficient financial markets'? We could begin by saying that an efficient market is one where financial securities are priced fairly to reflect all the relevant information at a particular point in time. A leading academic expert on finance, Eugene Fama, states that, 'in an efficient market competition among many intelligent participants leads to a situation where, at any point in time, actual prices of individual securities already reflect the effects of information, based both on events that have already occurred, and on events which, as of now, the market expects to take place in the future'. In other words, in an efficient market, at any point in time, the actual price will be a good estimate of its intrinsic value. This proposition is based on several assumptions that are normally made for explaining working of perfectly competitive markets. Although in the real world some of these assumptions are not fully satisfied, the proponents of Efficient Market Hypothesis, or EMH, refer to a large amount of empirical research, carried out over the last forty years, to argue that financial markets are broadly efficient. In other words, it is difficult to earn more than risk adjusted returns, based on the use of past or presently available information. Efficient Market Hypothesis also proposes three distinct forms of market efficiency. These are weak form, semi-strong form, and strong form. Let's consider each one in turn. Weak form Efficient Market Hypothesis says that the current price of securities reflects only historical information that is publicly available. Therefore one cannot use this information to predict future movements and earn abnormal returns. So in a weak form efficient market the technical analysis, or chart analysis, of prices is unlikely to earn higher returns on a consistent basis than what one would earn from a randomly selected portfolio of securities. Semi-strong form Efficient Market Hypothesis is a more rigorous form. With semi-strong form market prices reflect all publicly available information. In other words, not only is past information reflected in current prices, but the announcement of any new relevant information is quickly digested by the market participants. The participants analyse the likely impact of such information, and almost instantaneously react by deciding to buy, hold or sell securities. This results in the adjustment of prices to new equilibrium intrinsic values. Although it is difficult to define precisely what constitutes relevant publicly available information, a large body of empirical research, particularly in the well developed financial markets in the USA and UK, suggests that markets are semi-strong form efficient in these countries. An important issue raised by this conclusion relates to the usefulness of fundamental analysis in investment decisions. Fundamental analysis involves the systematic study of companies, sectors, and the macro economy. It can be questioned whether in a semi-strong form efficient market fundamental analysis can consistently produce better returns than the risk adjusted returns on a randomly selected portfolio. But whilst there is evidence that a carefully constructed portfolio based on fundamental analysis does not outperform a randomly selected portfolio on consistent basis, this does not mean fundamental analysis is irrelevant. The random portfolio results might reflect the impact of fundamental analysis used by a large number of investors in making their decisions. Strong form Efficient Market Hypothesis states that the prices of securities reflect all relevant information which includes historical, current publicly available, and any privately held information. The implication is that current prices are the best estimate of the intrinsic value of a security, and someone with private access to inside information cannot earn abnormal returns based on such information. This is the most rigorous form of information processing efficiency by the market. However, market regulations in most countries ban trading based on inside information. This makes it very difficult to obtain evidence on the usefulness of insider or private information as it would be difficult to get co-operation for any research from investors who might have access to, and who might make use of this private information.