What is Market Efficiency Hypothesis?

Worksheet

The EMH states that asset prices incorporate all public and private information, so investors cannot predictably beat the market by trading on known data.

Questions

1. EMH implies that technical analysis…
A) always works
B) cannot consistently beat the market (weak-form EMH)
C) is the most profitable strategy
D) predicts future prices perfectly

2. If EMH is semi-strong, what makes money?
A) Trading on public news
B) Technical analysis alone
C) Random selection
D) Random portfolios, not skill

3. A stock drops 5% on negative earnings news. In efficient markets…
A) you can profit by shorting
B) the price instantly reflects the news; no opportunity to profit
C) technical traders will profit
D) fundamental analysis will work

4. Why is insider trading illegal if EMH is true?
A) It doesn't matter — EMH says it can't work
B) Strong-form EMH is not realistic; insiders can profit from private info
C) The government wants to be fair
D) Markets are perfectly efficient

5. A company announces 15% profit growth (public news). In efficient markets, what happens?

6. An analyst finds a 'pattern' in past stock prices suggesting future rises. Will it work?

7. An insider knows about a merger before it's public. Can they profit?

8. Define: What is the Efficient Market Hypothesis?

9. Define: Name the three forms of EMH.

10. Define: Does EMH say you can beat the market?

Answer Key

1. B) cannot consistently beat the market (weak-form EMH) — Weak-form EMH says past prices are already in the current price, so technical patterns have no predictive power.
2. D) Random portfolios, not skill — Semi-strong EMH means public news is instantly priced in — only random luck or private info can beat the market.
3. B) the price instantly reflects the news; no opportunity to profit — In semi-strong EMH, news is priced instantly — by the time you see it, it's already in the price.
4. B) Strong-form EMH is not realistic; insiders can profit from private info — Insider trading laws imply strong-form EMH does NOT hold — private info CAN generate abnormal returns, so it must be regulated.
5. Weak form: History can't predict this announcement. Semi-strong: Price jumps instantly; the news is in the price. No investor can profit by trading after the announcement — it's already priced in.
6. In weak-form efficient markets, historical patterns have no predictive power. Past price movements are already reflected in current prices. The analyst cannot consistently beat the market using technical analysis.
7. In strong-form efficiency, even insiders cannot profit — all info is in the price. But strong-form EMH is rare (insider trading laws exist for a reason). In reality, insiders CAN profit (violating strong-form EMH).
8. EMH states that asset prices reflect all available info instantly, making consistent abnormal returns impossible.
9. Weak form (past prices), semi-strong (public info), strong form (all info, including private).
10. No — in efficient markets, prices move too fast for superior analysis to generate excess returns.