

Chapter 8 The Efficient Market Hypothesis

2. c

3. c

4. b

5. c

6. b

7. a

8. b

9. c

10. c

11. d

12. Assumptions supporting passive management are:

- a. informational efficiency
- b. primacy of diversification motives

Active management is supported by the opposite assumptions, in particular, that pockets of market inefficiency exist.

14. No, this is not a violation of the EMH. Microsoft's continuing large profits do not imply that stock market investors who purchased Microsoft shares after its success already was evident would have earned a high return on their investments.

15. No, this is not a violation of the EMH. This empirical tendency does not provide investors with a tool that will enable them to earn abnormal returns; in other words, it does not suggest that investors are failing to use all available information. An investor could not use this phenomenon to choose undervalued stocks today. The phenomenon instead reflects the fact that dividends occur as a response to good performance. After the fact, the stocks that happen to have performed the best will pay higher dividends, but this does not imply that you can identify the best performers early enough to earn abnormal returns.

16. While positive beta stocks respond well to favorable new information about the economy's progress through the business cycle, these should not show abnormal returns around already anticipated events. If a recovery, for example, is already anticipated, the actual recovery is not news. The stock price should already reflect the coming recovery.
- 17.
- a. Consistent. Half of all managers should outperform the market based on pure luck in any year.
 - b. Violation. This would be the basis for an "easy money" rule: simply invest with last year's best managers.
 - c. Consistent. Predictable volatility does not convey a means to earn abnormal returns.
 - d. Violation. The abnormal performance ought to occur in January, when the increased earnings are announced.
 - e. Violation. Reversals offer a means to earn easy money: simply buy last week's losers.
18. The phrase would be correct if it were modified to say "expected risk adjusted returns." Securities all have the same risk adjusted expected return, however, actual results can and do vary. Unknown events cause certain securities to outperform others. This is not known in advance so expectations are set by known information.
23. Over the long haul, there is an expected upward drift in stock prices based on their fair expected rates of return. The fair expected return over any single day is very small (e.g., 12% per year is only about 0.03% per day), so that on any day the price is virtually equally likely to rise or fall. However, over longer periods, the small expected daily returns cumulate, and upward moves are indeed more likely than downward ones.
24. You should buy the stock. In your view, the firm's management is not as bad as everyone else believes it to be. Therefore, you view the firm as undervalued by the market. You are less pessimistic about the firm's prospects than the beliefs built into the stock price.
26. The market may have anticipated even greater earnings. Compared to prior expectations, the announcement was a disappointment.