FIN 366: INVESTMENTS
BRIEFING

Chapters 8&9: Efficient Market Hypothesis & Behavioral Critique

The **Efficient Market Hypothesis (EMH)** is the idea that stock prices reflect all available information. Stock prices therefore follow a **random walk**, or move unpredictably from one period to the next. There are three versions of the EMH: (1) **weak form** whereby stock prices reflect all historical market trading data, (2) **semi-strong form**, where historical information and firm prospects are reflected in the stock price, and (3) **strong-form**, where all relevant *public* and *private* information is reflected in stock prices. **Fundamental analysis** is the use of firms' prospects, dividends, and financial condition to make trading decisions. **Technical analysis** is the examination of historical stock prices to make trading decisions. By the EMH, neither should be effective in generating consistent risk-adjusted returns. Yet, there is a **role for financial management** in diversification, tax planning, and retirement planning. Whether markets are truly efficient is difficult to answer based on the **magnitude issue** (difficult to uncover small inefficiencies), **selection bias** (profitable inefficiencies are not revealed by traders), and **lucky event issues** (outperformance over time can persist solely due to luck). **Anomalies** are patterns of returns that seemingly contradict the EMH, such as price **momentum**, **small** and **neglected firm overperformance**, value stock outperformance, and irrational increases in asset prices (**bubbles**). Some proponents of the EMH argue that such anomalies are uncovered through **data mining,** or searching through data until a pattern is uncovered. **Behavioral finance** argues that irrationalities in human behavior characterize investor decisions which can lead to profitable trading strategies. Such human traits as **overconfidence, conservatism** (investors being slow to update their beliefs), and **confirmation bias** (where investors dig for evidence to support their preconceived notions) prevent markets from being efficient as the EMH suggests. The **Adaptive Markets Hypothesis** seeks to reconcile the differences between the EMH and behavioral finance, arguing that markets are largely efficient, but irrationalities may arise in periods of uncertainty until investors learn from their environment.