FINM3407 - Behavioural Finance

Challenges to Market Efficiency

Tutorial 3 Questions

Note: This topic has more questions than can be covered in a 2-hour session. The questions to be covered by your tutor are indicated by an asterisk (*); the rest questions should be viewed as extra practice problems.

In this tutorial, we are going to cover the following relevant topics: Efficient Market Hypothesis and Challenges to Market Efficiency.

There are a few references reading for these two relevant topics:

AckertDeaves Chapters 4

Investments, 12th Edition, By Zvi Bodie and Alex Kane and Alan Marcus Chapter 11/12

1. *Differentiate the following terms/concepts:

a. Momentum and reversal

b. Value and growth stocks

c. Fundamental risk and noise-trader risk

d. Carve-out and stub value

2. *Refer back to the set of exchange rates in the "Support 3 (from the textbook): There are no limits to arbitrage" section earlier in the chapter. Describe a profitable arbitrage strategy if x = 105.

To illustrate how this works, in May 2008 the following three foreign exchange rates among dollars, euros, and yen were observed (x will be explained):

Currency pair	Rate
¥/€	159.3403
€/$	0.6455
¥/$	x

3. *Arbitrage is limited because the wealth of arbitrageurs is limited. Discuss this statement in the context of those who are managing their own money and those who are managing other people's money.

4. *What is data snooping? What sort of empirical evidence is useful for obviating this critique?

5. ***What are the three supports on which market efficiency rests? Why is it that only one of them is required?**

6. ***Define market efficiency. What are the key assumptions of an efficient market hypothesis (EMH)?**

7. **Discuss the different forms of market efficiency. How do they differ from one another?**

8. ***Identify some of the main challenges to market efficiency. Give specific examples for each.**

9. ***Discuss the concept of information asymmetry. How does it challenge market efficiency?**

10. ***What role does irrational behavior play in challenging the Efficient Market Hypothesis?**

11. ***What is meant by "behavioral finance"? How does it challenge traditional views on market efficiency?**

12. ***Discuss the impact of market manipulation on market efficiency. Provide some real-life examples.**

13. ***Analyze the role of high-frequency trading in challenging market efficiency.**

14. ***In your opinion, are financial markets truly efficient? Support your position with evidence.**

15. ***Discuss the role of regulation in maintaining market efficiency. Can over-regulation pose a challenge to market efficiency?**

16. *Question: Triangular arbitrage in foreign exchange markets

Consider the following exchange rates:

1 USD = 0.85 EUR (USD/EUR)

1 EUR = 130 JPY (EUR/JPY)

1 USD = 105 JPY (USD/JPY)

You start with 10,000 USD. Could you take advantage of a triangular arbitrage opportunity involving the Euro (EUR), the US dollar (USD), and the Japanese yen (JPY)? If yes, what would be your profit?

Hint: Please work out the synthetic cross rate between a currency pair and compare with the quoted prevailing exchange rate.

17. *Match each example to one of the following behavioral characteristics.

	Example		Characteristic
a.	Investors are slow to update their beliefs when given new evidence.	i.	Disposition effect
b.	Investors are reluctant to bear losses caused by their unconventional decisions.	ii.	Representativeness bias
c.	Investors exhibit less risk tolerance in their retirement accounts versus their other stock accounts.	iii.	Regret avoidance
d.	Investors are reluctant to sell stocks with “paper” losses.	iv.	Conservatism bias
e.	Investors disregard sample size when forming views about the future from the past	v.	Mental accounting