Book Homework chapter 12

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12.25

Heretics would try to show the market is not efficient by proving that prices do not reflect all available information and some people can predict the future return than the market can. If we fail to find these evidences and find out that the market has set the price correctly by using all the available information, we can conclude that the market is quite efficient.

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Efficient market:

Prices reflect all available information and people cannot predict future return better than the market.

Perfect market:

1. No differences in opinion
2. Infinitely many investors and firms
3. No transaction cost
4. No taxes

Perfect market implies efficient market, but efficient market does not imply perfect market.

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Since prices will reflect all available information in the efficient market, local knowledge will not be a privilege for local people to determine whether the prices are set correctly. Thus, in an efficient market, this recommendation may not be very helpful.

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Even the stock market is perfect an efficient, we still need to hold a well-diversified portfolio to meet risk-reward preference. A perfect and efficient stock market can only help us to be certain that all stocks are correctly priced.

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1. weak market efficiency: people cannot earn excess return only based on the historical price patterns.

2. semistrong market efficiency: people cannot earn excess return based on either fundamental analysis or historical price patterns.

3. strong market efficiency: nobody can earn excess return from the market since stock prices reflect all public and private information.

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In an efficient market, people will still collect information and prices contain a lot of information. Efficient market indicates that prices reflect all available information, but the insider information could still be used to beat the market as well as fundamental analysis. Thus, it is not an impossible concept.

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1. True believer: financial prices always reflect the best NPV of all future cashflow.

2. Firm believer: financial prices sometimes deviate from the best NPV of all future cashflow because of transaction cost and it will be impossible to find good bets.

3. Mild believer: financial prices sometimes deviate from the best NPV of all future cashflow but it is possible to find a few better bets.

4. Nonbeliever: financial prices regularly deviate from the best NPV of all future cashflow and investors can obtain great bets from it.

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