6.03 Market Efficiency

Question 1
Which of the following types of preferred stock is *least likely* to share in a company's operating performance?
A. Cumulative
B. Convertible
C. Participating

Question 2
A stock exchange opens in a country that previously had only over-the-counter equity trading. All else being equal, stock market efficiency will *most likely*:
A. increase.
B. decrease.
C. remain the same.

Question 3
The semi-strong form of the efficient market hypothesis assumes that security prices fully reflect:
A. only publicly available information.
B. both public and private information.
C. only historical price and volume information.

Question 4
An investor pursues a strategy of:

- selling stocks whose total return over the past 3 years has outperformed the market and
- buying stocks whose total return has underperformed the market over the same period.

This investor is *most likely* attempting to earn abnormal returns based which of the following market anomalies?
A. Value effect
B. Earnings surprise
C. Overreaction effect

Question 5
If securities markets are semi-strong-form efficient, this *most likely* implies that:
A. they are not weak-form efficient.
B. passive management will outperform active management.
C. passive managers can beat the market on a consistent basis.

Question 6
A novice investor experienced poor returns with two small-cap stocks of companies that eventually went bankrupt. Recently, an investment professional recommended a new small-cap stock backed by strong financial results and growth projections. The investor immediately

dismissed the recommendation, stating, "Not another small-cap stock—it's going to make me lose money again!" The investor's behavioral bias is *best* described as:
A. survivorship.
B. mental accounting.
C. representativeness.

Question 7
Which of the following market anomalies is inconsistent with semi-strong form market efficiency?
A. Initial public offering
B. Earnings surprise effect
C. Closed-end fund discount

Question 8
An investor holds a company's stock, believing its price will increase based on forecasts produced by a proprietary model. Following the latest earnings release, the investor updates the model and believes that the stock is overvalued and the price will decrease. However, the stock rises following earnings. Seeing this, the investor decides to hold the stock. The investor's behavior is *best* described as:
A. herding.
B. loss aversion.
C. conservatism.

Question 9
Which of the following is *most likely* to decrease market efficiency?
A. Limiting arbitrage
B. Enforcing fair markets
C. Permitting foreign investment

Question 10
The semi-strong efficient market hypothesis implies abnormal returns may be consistently achieved by acting on:
A. inside information.
B. publicly available information.
C. nonmaterial nonpublic information.

Question 11
An analyst forecasts current year EPS of $0.21 for an equipment manufacturing company. During the middle of the year, the company announces that it is experiencing unforeseen supply chain issues that will severely reduce its earnings. The analyst re-issues the original EPS forecast of $0.21, citing that the company always had strong fundamentals. This behavior is *best* explained as:

A. conservatism.
B. loss aversion.
C. mental accounting.

Question 12
An investor observes that a portfolio manager with a proven record of profitable investing has reduced its holdings in a stock that the investor currently owns and for which the investor has a large unrealized gain. Many other investors sold the stock after the portfolio manager's sales. The investor believes that the stock's long-term prospects are still good but decides to sell the stock anyway. The investor's behavior is *most likely* the result of:
A. herding.
B. risk aversion.
C. information cascades.

Question 13
A high-growth stock soars 300% over a two-year period. After conducting due diligence, an investor buys the stock, which subsequently underperforms the market by 40% over a short period of time. The investor believes the market is pricing the stock irrationally and continues to hold it. Based on the information provided, which of the following biases is *best* exemplified by the investor's behavior?
A. Risk aversion
B. Overconfidence
C. Mental accounting

Question 14
Unlike weak and semi-strong forms of the efficient market hypothesis, the strong form *most likely* holds that asset prices reflect information from:
A. historical market data.
B. company financial reports.
C. material nonpublic information.

Question 15
Which of the following *best* describes an asset's intrinsic value? Intrinsic value is:
A. lower than its market value for an undervalued asset.
B. the price for which market participants can buy or sell the asset.
C. generally accepted as accurately reflected by market value in an efficient market.

Question 16
In security markets that are semi-strong-form efficient, passive investment strategies will *most likely*:
A. outperform active strategies.
B. underperform active strategies.
C. perform the same as active strategies.

Question 17
Which of the following market anomalies is *inconsistent* with semi-strong form market efficiency?
A. The value effect
B. The January effect
C. Closed-end fund discount

Question 18
An overvalued asset *most likely* indicates that the asset's intrinsic value is less than its:
A. fair value.
B. market value.
C. present value of expected future cash flows.

Question 19
A market that is informationally efficient is *most likely* one where security prices:
A. accurately predict new information.
B. reflect all public and private information.
C. react quickly and rationally to new information.

Question 20
If a country's security markets are semi-strong form efficient, an investor would *most likely* be able to generate abnormal returns using:
A. only technical analysis.
B. only fundamental analysis.
C. neither technical nor fundamental analysis.

Question 21
After an election, new political leadership in a country allows more flexibility on the frequency of financial reporting. Consequently, many companies report financial results less often. Market efficiency will *most likely*:
A. decrease.
B. remain the same.
C. increase.

Question 22
Which of the following *best* describes the anomaly of earning abnormal profits by using only past market data?
A. The momentum anomaly
B. The earnings surprise anomaly
C. The initial public offering anomaly

Question 23
A country's financial markets are weak-form efficient. This implies that it is impossible to obtain consistent, abnormal returns in the country's markets using:

A. technical analysis.
B. insider information.
C. fundamental analysis.

Question 24
All else equal, a company's book value of equity is *most likely* to decrease when the:
A. company stops paying common dividends.
B. company reports a large accumulated loss.
C. company's stock price falls below par value.

Question 25
According to the Efficient Market Hypothesis, if a market is semi-strong form efficient, active management's net-of-fees returns to investors are *most likely*:
A. less than passive management's.
B. equivalent to passive management's.
C. greater than passive management's.

Question 26
A portfolio manager uses an active management strategy based on only historical and publicly available information and achieves abnormal returns. The manager is trading in a market *best* described as:
A. weak form efficient.
B. semi-strong form efficient.
C. strong form efficient.

Question 27
Active management is *most likely* to outperform passive management on a risk-adjusted basis when markets are:
A. informationally and operationally efficient.
B. informationally efficient and operationally inefficient.
C. informationally inefficient and operationally efficient.