Chapter 14
Efficient Capital Markets and Behavioral Challenges

Multiple Choice Questions

1. An efficient capital market is one in which:
A. brokerage commissions are zero.
B. taxes are irrelevant.
C. securities always offer a positive rate of return to investors.
D. security prices are guaranteed by the U.S. Securities and Exchange Commission to be fair.
E. security prices reflect available information.

2. The notion that actual capital markets, such as the NYSE, are fairly priced is called the:
A. Efficient Markets Hypothesis (EMH).
B. Law of One Price.
C. Open Markets Theorem.
D. Laissez-Faire Axiom.
E. Monopoly Pricing Theorem.

3. The hypothesis that market prices reflect all available information of every kind is called _____ form efficiency.
A. open
B. strong
C. semistrong
D. weak
E. stable

4. The hypothesis that market prices reflect all publicly available information is called _____ form efficiency.
A. open
B. strong
C. semistrong
D. weak
E. stable

5. The hypothesis that market prices reflect all historical information is called _____ form efficiency.
A. open
B. strong
C. semistrong
D. weak
E. stable

6. In an efficient market, the price of a security will:
A. always rise immediately upon the release of new information with no further price adjustments related to that information.
B. react to new information over a two-day period after which time no further price adjustments related to that information will occur.
C. rise sharply when new information is first released and then decline to a new stable level by the following day.
D. react immediately to new information with no further price adjustments related to that information.
E. be slow to react for the first few hours after new information is released allowing time for that information to be reviewed and analyzed.

7. If the financial markets are efficient, then investors should expect their investments in those markets to:
A. earn extraordinary returns on a routine basis.
B. generally have positive net present values.
C. generally have zero net present values.
D. produce arbitrage opportunities on a routine basis.
E. produce negative returns on a routine basis.

8. Which one of the following statements is correct concerning market efficiency?
A. Real asset markets are more efficient than financial markets.
B. If a market is efficient, arbitrage opportunities should be common.
C. In an efficient market, some market participants will have an advantage over others.
D. A firm will generally receive a fair price when it sells shares of stock.
E. New information will gradually be reflected in a stock's price to avoid any sudden change in the price of the stock.

9. According to the efficient market hypothesis, financial markets fluctuate daily because they:
A. are inefficient.
B. slowly react to new information.
C. are continually reacting to new information.
D. offer tremendous arbitrage opportunities.
E. only reflect historical information.

10. Insider trading does not offer any advantages if the financial markets are:
A. weak form efficient.
B. semiweak form efficient.
C. semistrong form efficient.
D. strong form efficient.
E. inefficient.

11. According to theory, studying historical prices in order to identify mispriced stocks will not work in markets that are _____ efficient.
I. weak form
II. semistrong form
III. strong form
A. I only
B. II only
C. I and II only
D. II and III only
E. I, II, and III

12. Which of the following tend to reinforce the argument that the financial markets are efficient?
I. Information spreads rapidly in today's world.
II. There is tremendous competition in the financial markets.
III. Market prices continually fluctuate.
IV. Market prices react suddenly to unexpected news announcements.
A. I and III only
B. II and IV only
C. I, II, and III only
D. II, III, and IV only
E. I, II, III, and IV

13. If you excel in analyzing the future outlook of firms, you would prefer that the financial markets be ____ form efficient so that you can have an advantage in the marketplace.
A. weak
B. semiweak
C. semistrong
D. strong
E. perfect

14. Your best friend works in the finance office of the Delta Corporation. You are aware that this friend trades Delta stock based on information he overhears in the office. You know that this information is not known to the general public. Your friend continually brags to you about the profits he earns trading Delta stock. Based on this information, you would tend to argue that the financial markets are at best _____ form efficient.
A. weak
B. semiweak
C. semistrong
D. strong
E. perfect

15. The U.S. Securities and Exchange Commission periodically charges individuals for insider trading and claims those individuals have made unfair profits. Based on this fact, you would tend to argue that the financial markets are at best _____ form efficient.
A. weak
B. semiweak
C. semistrong
D. strong
E. perfect

16. Individuals that continually monitor the financial markets seeking mispriced securities:
A. tend to make substantial profits on a daily basis.
B. tend to make the markets more efficient.
C. are never able to find a security that is temporarily mispriced.
D. are always quite successful using only well-known public information as their basis of evaluation.
E. are always quite successful using only historical price information as their basis of evaluation.

17. Efficient capital markets are financial markets:
A. in which current market prices reflect available information.
B. in which current market prices reflect the present value of securities.
C. in which there is no excess profit from using available information.
D. All of the above.
E. None of the above.

18. If the efficient market hypothesis holds, investors should expect:
A. to earn only a normal return.
B. to receive a fair price for their securities.
C. to always be able to pick stocks that will outperform the market averages.
D. Both A and B.
E. Both B and C.

19. Financial managers can create value through financing decisions that:
A. reduce costs or increase subsidies.
B. increase the product prices.
C. create a new security.
D. Both A and B.
E. Both A and C.

20. In an efficient market when a firm makes an announcement of a new product or product enhancement with superior technology providing positive NPV, the price of the stock will:
A. rise gradually over the next few days.
B. decline gradually over the next few days.
C. rise on the same day to the new price.
D. stay at the same price, with no net effect.
E. drop on the same day to the new price.

21. An investor discovers that for a certain group of stocks, large positive price changes are always followed by large negative price changes. This finding is a violation of the:
A. moderate form of the efficient market hypothesis.
B. semistrong form of the efficient market hypothesis.
C. strong form of the efficient market hypothesis.
D. weak form of the efficient market hypothesis.
E. None of the above.

22. Which of the following would be indicative of inefficient markets?
A. Overreaction and reversion
B. Delayed response
C. Immediate and accurate response
D. Both A and B.
E. Both A and C.

23. When the stock price follows a random walk, the price today is said to be equal to the prior period price plus the expected return for the period with any remaining difference to the actual return due to:
A. a predictable amount based on the past prices.
B. a component based on new information unrelated to past prices.
C. the security's risk.
D. the risk free rate.
E. None of the above.

24. Which form of the efficient market hypothesis implies that security prices reflect only information contained in past prices?
A. Weak form
B. Semistrong form
C. Strong form
D. Hard form
E. Past form

25. If the weak form of efficient markets holds, then:
A. technical analysis is useless.
B. stock prices reflect all information contained in past prices.
C. stock prices follow a random walk.
D. All of the above.
E. None of the above.

26. Under the concept of an efficient market, a random walk in stock prices means that:
A. there is no driving force behind price changes.
B. technical analysts can predict future price movements to earn excess returns.
C. the unexplained portion of price change in one period is unrelated to the unexplained portion of price change in any other period.
D. the unexplained portion of price change in one period that can not be explained by expected return can only be explained by the unexplained portion of price change in a prior period.
E. None of the above.

27. A semistrong form efficient market is distinct from a weak form efficient market by:
A. incorporating only random movements in the price.
B. incorporating all publicly available information in the price.
C. incorporating inside information in the price.
D. All of the above.
E. None of the above.

28. If a market is strong form efficient, it also implies that:
A. semistrong form efficiency holds.
B. weak form efficiency holds.
C. one cannot earn abnormal returns with inside information.
D. Both A and C.
E. A, B and C.

29. An investor discovers that predictions about weather patterns published years in advance and found in the Farmer's Almanac are amazingly accurate. In fact, these predictions enable the investor to predict the health of the farm economy and therefore certain security prices. This finding is a violation of the:
A. moderate form of the efficient market hypothesis.
B. semistrong form of the efficient market hypothesis.
C. strong form of the efficient market hypothesis.
D. weak form of the efficient market hypothesis.
E. None of the above.

30. A lawyer works for a firm that advises corporate firms planning to sue other corporations for antitrust damages. He finds that he can "beat the market" by short-selling the stock of the firm that will be sued. This finding is a violation of the:
A. moderate form of the efficient market hypothesis.
B. semistrong form of the efficient market hypothesis.
C. strong form of the efficient market hypothesis.
D. weak form of the efficient market hypothesis.
E. None of the above.

31. An investor discovers that stock prices change drastically as a result of certain events. This finding is a violation of the:
A. moderate form of the efficient market hypothesis.
B. semistrong form of the efficient market hypothesis.
C. strong form of the efficient market hypothesis.
D. weak form of the efficient market hypothesis.
E. None of the above.

32. The semistrong form of the efficient market hypothesis states that:
A. all information is reflected in the price of securities.
B. security prices reflect all publicly available information.
C. future prices are predictable.
D. Both A and C.
E. None of the above.

33. The market price of a stock moves or fluctuates daily. This fluctuation is:
A. inconsistent with the semistrong efficient market hypothesis because prices should be stable.
B. inconsistent with the weak form efficient market hypothesis because all past information should be priced in.
C. consistent with the semistrong form of the efficient market hypothesis because as new information arrives daily prices will adjust to it.
D. consistent with the strong form because prices are controlled by insiders.
E. None of the above.

34. An investor who picks a portfolio by throwing darts at the financial pages:
A. believes that efficient markets will protect the portfolio from harm as all information is priced.
B. believes that riskier portfolios earn the same as less risky portfolios.
C. does so because stock prices do not matter; only cash flow generated matters.
D. Both A and C.
E. Both B and C.

35. Suppose that firms with unexpectedly high earnings earn abnormally high returns for several months after the announcement. This would be evidence of:
A. efficient markets in the weak form.
B. inefficient markets in the weak form.
C. efficient markets in the semistrong form.
D. inefficient markets in the semistrong form.
E. inefficient markets in the strong form.

36. Which of the following is not true about serial correlation?
A. It measures the correlation between the current return on a security and the current return on another security.
B. It involves only one security.
C. Positive serial correlation indicates a tendency for continuation.
D. Negative serial correlation indicates a tendency toward reversal.
E. Significant positive or negative serial correlation coefficients are indicative of market inefficiency in the weak form.

37. Which of the following is true?
A. A random walk for stock price changes is inconsistent with observed patterns in price changes.
B. If the stock market follows a random walk, price changes should be highly correlated.
C. If the stock market is weak form efficient, then stock prices follow a random walk.
D. All of the above.
E. Both B and C.

38. Event studies attempt to measure:
A. the influence of information released to the market on returns in days surrounding its announcement.
B. if the market is at least semistrong form efficient.
C. whether there is a significant reaction to public announcements.
D. All of the above.
E. None of the above.

39. The abnormal return in an event study is described as:
A. the return earned on the day of announcement for the stock.
B. the excess return earned on the day of announcement for the stock.
C. the total return earned for the investment holding period.
D. All of the above.
E. None of the above.

40. Evidence on stock prices finds that the sudden death of a chief executive officer causes stock prices to fall and the sudden death of an active founding chief executive officer causes stock price to rise. This contrary evidence happens because:
A. markets are inefficient and unsure of the real value of the events.
B. death is inevitable and market prices are random.
C. things simply happen.
D. the value of the founding executive was a negative to the firm.
E. None of the above.

41. Studies of the performance of professionally managed mutual funds find that these funds:
A. do not outperform a market index. Assuming mutual fund managers rely primarily on public information, this finding refutes the semistrong form of the efficient market hypothesis.
B. do not outperform a market index. Assuming mutual fund managers rely primarily on public information, this finding supports the semistrong form of the efficient market hypothesis.
C. outperform a market index. Assuming mutual fund managers rely primarily on public information, this finding refutes the semistrong form of the efficient market hypothesis.
D. outperform a market index. Assuming mutual fund managers rely primarily on public information, this finding supports the semistrong form of the efficient market hypothesis.
E. Both C and D.

42. Which of the following statements is true?
A. In efficient markets, a stock's price should change with the arrival of new information.
B. Average stock returns are higher in January than other months.
C. Studies by Fama and French and others find that returns of high book to market stocks are much higher than low book to market value stocks to be consistent with the efficient market hypothesis.
D. All of the above.
E. None of the above.

43. Which of the following is true?
A. Most empirical evidence is consistent with strong form efficiency.
B. Most empirical evidence is inconsistent with weak form efficiency.
C. Strong form market efficiency is not supported by the empirical evidence.
D. Both A and C.
E. Both B and C.

44. In examining the issue of whether the choice of accounting methods affects stock prices, studies have found that:
A. accounting depreciation methods can significantly affect stock prices.
B. switching depreciation methods can significantly affect stock prices.
C. accounting changes that increase accounting earnings also increases stock prices.
D. accounting changes can affect stock prices if the company were either to withhold information or provide incorrect information.
E. All of the above.

45. Market efficiency says:
A. prices may not reflect underlying value.
B. a good financial manager can time stock sales.
C. managers may profitablly speculate in foreign currency.
D. managers cannot boost stock prices through creative accounting.
E. None of the above.

46. The abnormal returns for initial public offerings over longer time periods seem to call market efficiency into question because:
A. the average returns at announcement are large and positive while the long-term results are much lower than the returns for seasoned equity offerings.
B. the average returns at announcement are small and negative while the long-term results are much lower than the returns for seasoned equity offerings.
C. the average returns at announcement are zero while the long-term results are much higher than the returns for seasoned equity offerings.
D. the average returns at announcement are large and positive while the long-term results are much higher than the returns for seasoned equity offerings.
E. the average returns at announcement are insignificant while the long-term results are much lower than the returns for seasoned equity offerings.

47. An example of financially irrational behavior is:
A. gambling in Las Vegas.
B. when a firm announces an increase in earnings and the stock price enjoys three days of large abnormal returns.
C. when a firm announces an increase in earnings and the stock price enjoys an immediate surge in value which is captured in one day.
D. Both A and B.
E. Both A and C.

48. Ritter's study of Initial Public Offerings (IPOs) showed that the post offering stock performance was:
A. less than the control group by about 2% in the five years following the IPO.
B. incorrectly priced at issuance because over the next five years the abnormal returns were greater than zero on average.
C. immaterial to the pricing of the IPO because future market performance is unknown at issuance.
D. equal across IPOs, irrespective of risk or which year they were issued.
E. All of the above.

49. If the securities market is efficient, an investor need only throw darts at the stock pages to pick securities and be just as well off.
A. This is true because there are no differences in risk and return.
B. This is true because in an efficient stock market prices do not fluctuate.
C. This is false because professional portfolio managers prefer to generate commissions by active trading.
D. This is false because investors may not hold a desirable risk-return combination in their portfolio.
E. This is false because the markets are controlled by the institutional investors.

50. Financial managers must be cognizant of market efficiency because:
A. manipulating earnings by accounting changes does not fool the market.
B. timing security sales is futile because without private information the current price reflects all known information.
C. there is limited price pressure from any large sale of stock depressing prices only momentarily before recovering to prior levels.
D. All of the above.
E. None of the above.

51. Event studies have been used to examine:
A. IPOs, SEOs, and other equity issuances.
B. changes in earnings.
C. mergers and acquisitions.
D. most financial events.
E. All of the above.

52. If the market is weak form efficient:
A. semistrong form efficiency holds.
B. strong form efficiency must hold.
C. semistrong form efficiency may hold.
D. markets are not weak form efficient.
E. None of the above.

53. In order to create value from capital budgeting decisions, the firm is likely to:
A. locate an unsatisfied demand for a particular product or service.
B. create a barrier to make it more difficult for other firms to compete.
C. produce products or services at a lower cost than the competition.
D. A and C.
E. A, B, and C.

54. Valuable financing opportunities can be created by:
A. fooling investors.
B. reducing costs or increasing subsidies.
C. the creation of a new security.
D. A and B.
E. A, B, and C.

55. The following time period(s) is/are consistent with the bubble theory:
A. the stock market crash of 1929.
B. the stock market crash of 1972.
C. the stock market crash of 1987.
D. A and C.
E. A, B, and C.

56. In the five years after the offering, ___ underperform matched control groups.
A. initial public offerings
B. seasoned equity offerings
C. bond offerings
D. A and B
E. A, B, and C

57. In the three years prior to a forced departure of management, stock prices, adjusted for market performance, on average will:
A. decline about 20%.
B. decline about 40%.
C. decline about 60%.
D. remain stable.
E. increase about 20%.

Essay Questions

58. Define the three forms of market efficiency.

59. Explain why it is that in an efficient market, investments have an expected NPV of zero.

60. Do you think the lessons from capital market history will hold for each year in the future? That is, as an example, if you buy small stocks will your investment always outperform U.S. Treasury bonds?

61. Suppose your cousin invests in the stock market and doubles her money in a single year while the market, on average, earned a return of only about 15%. Is your cousin's performance a violation of market efficiency?

62. Why should a financial decision maker such as a corporate treasurer or CFO be concerned with market efficiency?

Chapter 14 Efficient Capital Markets and Behavioral Challenges Answer Key

Multiple Choice Questions

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A. brokerage commissions are zero.
B. taxes are irrelevant.
C. securities always offer a positive rate of return to investors.
D. security prices are guaranteed by the U.S. Securities and Exchange Commission to be fair.
E. security prices reflect available information.

Difficulty level: Easy
Topic: EFFICIENT CAPITAL MARKET
Type: DEFINITIONS

2. The notion that actual capital markets, such as the NYSE, are fairly priced is called the:
A. Efficient Markets Hypothesis (EMH).
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D. Laissez-Faire Axiom.
E. Monopoly Pricing Theorem.

Difficulty level: Easy
Topic: EFFICIENT MARKETS HYPOTHESIS
Type: DEFINITIONS

3. The hypothesis that market prices reflect all available information of every kind is called _____ form efficiency.
A. open
B. strong
C. semistrong
D. weak
E. stable

Difficulty level: Easy
Topic: STRONG FORM EFFICIENCY
Type: DEFINITIONS

4. The hypothesis that market prices reflect all publicly available information is called _____ form efficiency.
A. open
B. strong
C. semistrong
D. weak
E. stable

Difficulty level: Easy
Topic: SEMI STRONG FORM EFFICIENCY
Type: DEFINITIONS

5. The hypothesis that market prices reflect all historical information is called _____ form efficiency.
A. open
B. strong
C. semistrong
D. weak
E. stable

Difficulty level: Easy
Topic: WEAK FORM EFFICIENCY
Type: DEFINITIONS

6. In an efficient market, the price of a security will:
A. always rise immediately upon the release of new information with no further price adjustments related to that information.
B. react to new information over a two-day period after which time no further price adjustments related to that information will occur.
C. rise sharply when new information is first released and then decline to a new stable level by the following day.
D. react immediately to new information with no further price adjustments related to that information.
E. be slow to react for the first few hours after new information is released allowing time for that information to be reviewed and analyzed.

Difficulty level: Medium
Topic: MARKET EFFICIENCY
Type: CONCEPTS

7. If the financial markets are efficient, then investors should expect their investments in those markets to:
A. earn extraordinary returns on a routine basis.
B. generally have positive net present values.
C. generally have zero net present values.
D. produce arbitrage opportunities on a routine basis.
E. produce negative returns on a routine basis.

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8. Which one of the following statements is correct concerning market efficiency?
A. Real asset markets are more efficient than financial markets.
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9. According to the efficient market hypothesis, financial markets fluctuate daily because they:
A. are inefficient.
B. slowly react to new information.
C. are continually reacting to new information.
D. offer tremendous arbitrage opportunities.
E. only reflect historical information.

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Type: CONCEPTS

10. Insider trading does not offer any advantages if the financial markets are:
A. weak form efficient.
B. semiweak form efficient.
C. semistrong form efficient.
D. strong form efficient.
E. inefficient.

Difficulty level: Easy
Topic: MARKET EFFICIENCY
Type: CONCEPTS

11. According to theory, studying historical prices in order to identify mispriced stocks will not work in markets that are _____ efficient.
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C. I and II only
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B. tend to make the markets more efficient.
C. are never able to find a security that is temporarily mispriced.
D. are always quite successful using only well-known public information as their basis of evaluation.
E. are always quite successful using only historical price information as their basis of evaluation.

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B. in which current market prices reflect the present value of securities.
C. in which there is no excess profit from using available information.
D. All of the above.
E. None of the above.

Difficulty level: Easy
Topic: EFFICIENT MARKETS
Type: CONCEPTS

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B. to receive a fair price for their securities.
C. to always be able to pick stocks that will outperform the market averages.
D. Both A and B.
E. Both B and C.

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19. Financial managers can create value through financing decisions that:
A. reduce costs or increase subsidies.
B. increase the product prices.
C. create a new security.
D. Both A and B.
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Difficulty level: Medium
Topic: VALUE CREATION
Type: CONCEPTS

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A. rise gradually over the next few days.
B. decline gradually over the next few days.
C. rise on the same day to the new price.
D. stay at the same price, with no net effect.
E. drop on the same day to the new price.

Difficulty level: Medium
Topic: EFFICIENT MARKET RESPONSE TO NEWS
Type: CONCEPTS

21. An investor discovers that for a certain group of stocks, large positive price changes are always followed by large negative price changes. This finding is a violation of the:
A. moderate form of the efficient market hypothesis.
B. semistrong form of the efficient market hypothesis.
C. strong form of the efficient market hypothesis.
D. weak form of the efficient market hypothesis.
E. None of the above.

Difficulty level: Medium
Topic: WEAK FORM EFFICIENT MARKET HYPOTHESIS
Type: CONCEPTS

22. Which of the following would be indicative of inefficient markets?
A. Overreaction and reversion
B. Delayed response
C. Immediate and accurate response
D. Both A and B.
E. Both A and C.

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Type: CONCEPTS

23. When the stock price follows a random walk, the price today is said to be equal to the prior period price plus the expected return for the period with any remaining difference to the actual return due to:
A. a predictable amount based on the past prices.
B. a component based on new information unrelated to past prices.
C. the security's risk.
D. the risk free rate.
E. None of the above.

Difficulty level: Medium
Topic: MARKET EFFICIENCY - RANDOM WALK
Type: CONCEPTS

24. Which form of the efficient market hypothesis implies that security prices reflect only information contained in past prices?
A. Weak form
B. Semistrong form
C. Strong form
D. Hard form
E. Past form

Difficulty level: Medium
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25. If the weak form of efficient markets holds, then:
A. technical analysis is useless.
B. stock prices reflect all information contained in past prices.
C. stock prices follow a random walk.
D. All of the above.
E. None of the above.

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B. technical analysts can predict future price movements to earn excess returns.
C. the unexplained portion of price change in one period is unrelated to the unexplained portion of price change in any other period.
D. the unexplained portion of price change in one period that can not be explained by expected return can only be explained by the unexplained portion of price change in a prior period.
E. None of the above.

Difficulty level: Medium
Topic: MARKET EFFICIENCY - RANDOM WALK
Type: CONCEPTS

27. A semistrong form efficient market is distinct from a weak form efficient market by:
A. incorporating only random movements in the price.
B. incorporating all publicly available information in the price.
C. incorporating inside information in the price.
D. All of the above.
E. None of the above.

Difficulty level: Medium
Topic: EFFICIENT MARKETS HYPOTHESIS
Type: CONCEPTS

28. If a market is strong form efficient, it also implies that:
A. semistrong form efficiency holds.
B. weak form efficiency holds.
C. one cannot earn abnormal returns with inside information.
D. Both A and C.
E. A, B and C.

Difficulty level: Medium
Topic: STRONG FORM EFFICIENT MARKETS HYPOTHESIS
Type: CONCEPTS

29. An investor discovers that predictions about weather patterns published years in advance and found in the Farmer's Almanac are amazingly accurate. In fact, these predictions enable the investor to predict the health of the farm economy and therefore certain security prices. This finding is a violation of the:
A. moderate form of the efficient market hypothesis.
B. semistrong form of the efficient market hypothesis.
C. strong form of the efficient market hypothesis.
D. weak form of the efficient market hypothesis.
E. None of the above.

Difficulty level: Medium
Topic: SEMISTRONG FORM EFFICIENT MARKETS HYPOTHESIS
Type: CONCEPTS

30. A lawyer works for a firm that advises corporate firms planning to sue other corporations for antitrust damages. He finds that he can "beat the market" by short-selling the stock of the firm that will be sued. This finding is a violation of the:
A. moderate form of the efficient market hypothesis.
B. semistrong form of the efficient market hypothesis.
C. strong form of the efficient market hypothesis.
D. weak form of the efficient market hypothesis.
E. None of the above.

Difficulty level: Medium
Topic: STRONG FORM EFFICIENT MARKETS HYPOTHESIS
Type: CONCEPTS

31. An investor discovers that stock prices change drastically as a result of certain events. This finding is a violation of the:
A. moderate form of the efficient market hypothesis.
B. semistrong form of the efficient market hypothesis.
C. strong form of the efficient market hypothesis.
D. weak form of the efficient market hypothesis.
E. None of the above.

Difficulty level: Challenge
Topic: EFFICIENT MARKETS AND EVENTS
Type: CONCEPTS

32. The semistrong form of the efficient market hypothesis states that:
A. all information is reflected in the price of securities.
B. security prices reflect all publicly available information.
C. future prices are predictable.
D. Both A and C.
E. None of the above.

Difficulty level: Easy
Topic: SEMISTRONG EFFICIENT MARKETS HYPOTHESIS
Type: CONCEPTS

33. The market price of a stock moves or fluctuates daily. This fluctuation is:
A. inconsistent with the semistrong efficient market hypothesis because prices should be stable.
B. inconsistent with the weak form efficient market hypothesis because all past information should be priced in.
C. consistent with the semistrong form of the efficient market hypothesis because as new information arrives daily prices will adjust to it.
D. consistent with the strong form because prices are controlled by insiders.
E. None of the above.

Difficulty level: Medium
Topic: SEMISTRONG EFFICIENT MARKETS HYPOTHESIS
Type: CONCEPTS

34. An investor who picks a portfolio by throwing darts at the financial pages:
A. believes that efficient markets will protect the portfolio from harm as all information is priced.
B. believes that riskier portfolios earn the same as less risky portfolios.
C. does so because stock prices do not matter; only cash flow generated matters.
D. Both A and C.
E. Both B and C.

Difficulty level: Medium
Topic: DART THROWERS PORTFOLIOS
Type: CONCEPTS

35. Suppose that firms with unexpectedly high earnings earn abnormally high returns for several months after the announcement. This would be evidence of:
A. efficient markets in the weak form.
B. inefficient markets in the weak form.
C. efficient markets in the semistrong form.
D. inefficient markets in the semistrong form.
E. inefficient markets in the strong form.

Difficulty level: Medium
Topic: MARKET EFFICIENCY
Type: CONCEPTS

36. Which of the following is not true about serial correlation?
A. It measures the correlation between the current return on a security and the current return on another security.
B. It involves only one security.
C. Positive serial correlation indicates a tendency for continuation.
D. Negative serial correlation indicates a tendency toward reversal.
E. Significant positive or negative serial correlation coefficients are indicative of market inefficiency in the weak form.

Difficulty level: Challenge
Topic: SERIAL CORRELATION
Type: CONCEPTS

37. Which of the following is true?
A. A random walk for stock price changes is inconsistent with observed patterns in price changes.
B. If the stock market follows a random walk, price changes should be highly correlated.
C. If the stock market is weak form efficient, then stock prices follow a random walk.
D. All of the above.
E. Both B and C.

Difficulty level: Medium
Topic: MARKET EFFICIENCY
Type: CONCEPTS

38. Event studies attempt to measure:
A. the influence of information released to the market on returns in days surrounding its announcement.
B. if the market is at least semistrong form efficient.
C. whether there is a significant reaction to public announcements.
D. All of the above.
E. None of the above.

Difficulty level: Easy
Topic: EVENT STUDIES
Type: CONCEPTS

39. The abnormal return in an event study is described as:
A. the return earned on the day of announcement for the stock.
B. the excess return earned on the day of announcement for the stock.
C. the total return earned for the investment holding period.
D. All of the above.
E. None of the above.

Difficulty level: Medium
Topic: EVENT STUDY ABNORMAL RETURNS
Type: CONCEPTS

40. Evidence on stock prices finds that the sudden death of a chief executive officer causes stock prices to fall and the sudden death of an active founding chief executive officer causes stock price to rise. This contrary evidence happens because:
A. markets are inefficient and unsure of the real value of the events.
B. death is inevitable and market prices are random.
C. things simply happen.
D. the value of the founding executive was a negative to the firm.
E. None of the above.

Difficulty level: Easy
Topic: EVENT STUDY INTERPRETATION
Type: CONCEPTS

41. Studies of the performance of professionally managed mutual funds find that these funds:
A. do not outperform a market index. Assuming mutual fund managers rely primarily on public information, this finding refutes the semistrong form of the efficient market hypothesis.
B. do not outperform a market index. Assuming mutual fund managers rely primarily on public information, this finding supports the semistrong form of the efficient market hypothesis.
C. outperform a market index. Assuming mutual fund managers rely primarily on public information, this finding refutes the semistrong form of the efficient market hypothesis.
D. outperform a market index. Assuming mutual fund managers rely primarily on public information, this finding supports the semistrong form of the efficient market hypothesis.
E. Both C and D.

Difficulty level: Medium
Topic: MUTUAL FUNDS AND EFFICIENT MARKETS
Type: CONCEPTS

42. Which of the following statements is true?
A. In efficient markets, a stock's price should change with the arrival of new information.
B. Average stock returns are higher in January than other months.
C. Studies by Fama and French and others find that returns of high book to market stocks are much higher than low book to market value stocks to be consistent with the efficient market hypothesis.
D. All of the above.
E. None of the above.

Difficulty level: Medium
Topic: EFFICIENCY AND RETURNS
Type: CONCEPTS

43. Which of the following is true?
A. Most empirical evidence is consistent with strong form efficiency.
B. Most empirical evidence is inconsistent with weak form efficiency.
C. Strong form market efficiency is not supported by the empirical evidence.
D. Both A and C.
E. Both B and C.

Difficulty level: Medium
Topic: TESTS OF MARKET EFFICIENY
Type: CONCEPTS

44. In examining the issue of whether the choice of accounting methods affects stock prices, studies have found that:
A. accounting depreciation methods can significantly affect stock prices.
B. switching depreciation methods can significantly affect stock prices.
C. accounting changes that increase accounting earnings also increases stock prices.
D. accounting changes can affect stock prices if the company were either to withhold information or provide incorrect information.
E. All of the above.

Difficulty level: Medium
Topic: ACCOUNTING METHODS AND STOCK PRICES
Type: CONCEPTS

45. Market efficiency says:
A. prices may not reflect underlying value.
B. a good financial manager can time stock sales.
C. managers may profitablly speculate in foreign currency.
D. managers cannot boost stock prices through creative accounting.
E. None of the above.

Difficulty level: Medium
Topic: MARKET EFFICIENCY
Type: CONCEPTS

46. The abnormal returns for initial public offerings over longer time periods seem to call market efficiency into question because:
A. the average returns at announcement are large and positive while the long-term results are much lower than the returns for seasoned equity offerings.
B. the average returns at announcement are small and negative while the long-term results are much lower than the returns for seasoned equity offerings.
C. the average returns at announcement are zero while the long-term results are much higher than the returns for seasoned equity offerings.
D. the average returns at announcement are large and positive while the long-term results are much higher than the returns for seasoned equity offerings.
E. the average returns at announcement are insignificant while the long-term results are much lower than the returns for seasoned equity offerings.

Difficulty level: Easy
Topic: ABNORMAL RETURNS FOR IPOs
Type: CONCEPTS

47. An example of financially irrational behavior is:
A. gambling in Las Vegas.
B. when a firm announces an increase in earnings and the stock price enjoys three days of large abnormal returns.
C. when a firm announces an increase in earnings and the stock price enjoys an immediate surge in value which is captured in one day.
D. Both A and B.
E. Both A and C.

Difficulty level: Medium
Topic: RATIONAL BEHAVIOR
Type: CONCEPTS

48. Ritter's study of Initial Public Offerings (IPOs) showed that the post offering stock performance was:
A. less than the control group by about 2% in the five years following the IPO.
B. incorrectly priced at issuance because over the next five years the abnormal returns were greater than zero on average.
C. immaterial to the pricing of the IPO because future market performance is unknown at issuance.
D. equal across IPOs, irrespective of risk or which year they were issued.
E. All of the above.

Difficulty level: Medium
Topic: THE TIMING DECISION - IPO RESEARCH
Type: CONCEPTS

49. If the securities market is efficient, an investor need only throw darts at the stock pages to pick securities and be just as well off.
A. This is true because there are no differences in risk and return.
B. This is true because in an efficient stock market prices do not fluctuate.
C. This is false because professional portfolio managers prefer to generate commissions by active trading.
D. This is false because investors may not hold a desirable risk-return combination in their portfolio.
E. This is false because the markets are controlled by the institutional investors.

Difficulty level: Medium
Topic: DART THROWING
Type: CONCEPTS

50. Financial managers must be cognizant of market efficiency because:
A. manipulating earnings by accounting changes does not fool the market.
B. timing security sales is futile because without private information the current price reflects all known information.
C. there is limited price pressure from any large sale of stock depressing prices only momentarily before recovering to prior levels.
D. All of the above.
E. None of the above.

Difficulty level: Medium
Topic: MARKET EFFICIENCY
Type: CONCEPTS

51. Event studies have been used to examine:
A. IPOs, SEOs, and other equity issuances.
B. changes in earnings.
C. mergers and acquisitions.
D. most financial events.
E. All of the above.

Difficulty level: Easy
Topic: EVENT STUDIES
Type: CONCEPTS

52. If the market is weak form efficient:
A. semistrong form efficiency holds.
B. strong form efficiency must hold.
C. semistrong form efficiency may hold.
D. markets are not weak form efficient.
E. None of the above.

Difficulty level: Easy
Topic: WEAK FORM EFFICIENT MARKETS HYPOTHESIS
Type: CONCEPTS

53. In order to create value from capital budgeting decisions, the firm is likely to:
A. locate an unsatisfied demand for a particular product or service.
B. create a barrier to make it more difficult for other firms to compete.
C. produce products or services at a lower cost than the competition.
D. A and C.
E. A, B, and C.

Difficulty level: Medium
Topic: VALUE CREATION
Type: CONCEPTS

54. Valuable financing opportunities can be created by:
A. fooling investors.
B. reducing costs or increasing subsidies.
C. the creation of a new security.
D. A and B.
E. A, B, and C.

Difficulty level: Easy
Topic: VALUE CREATION
Type: CONCEPTS

55. The following time period(s) is/are consistent with the bubble theory:
A. the stock market crash of 1929.
B. the stock market crash of 1972.
C. the stock market crash of 1987.
D. A and C.
E. A, B, and C.

Difficulty level: Medium
Topic: BUBBLE THEORY
Type: CONCEPTS

56. In the five years after the offering, ___ underperform matched control groups.
A. initial public offerings
B. seasoned equity offerings
C. bond offerings
D. A and B
E. A, B, and C

Difficulty level: Medium
Topic: STOCK MARKET PERFORMANCE
Type: CONCEPTS

57. In the three years prior to a forced departure of management, stock prices, adjusted for market performance, on average will:
A. decline about 20%.
B. decline about 40%.
C. decline about 60%.
D. remain stable.
E. increase about 20%.

Difficulty level: Medium
Topic: STOCK PERFORMANCE
Type: CONCEPTS

Essay Questions

58. Define the three forms of market efficiency.

The student should present a straightforward discussion of weak (all past prices are in the current price), semistrong form (all public information is in the current price), and strong form (all information is in the current price) market efficiency.

Topic: EFFICIENT MARKETS
Type: ESSAYS

59. Explain why it is that in an efficient market, investments have an expected NPV of zero.

In an efficient market, prices are "fair" so that the cost of an investment is neither too high nor too low. Thus, on average, investments in that market will yield a zero NPV. Investors get exactly what they pay for when they buy a security in an efficient market and firms get exactly what their stocks and bonds are worth when they sell them.

Topic: EFFICIENT MARKETS
Type: ESSAYS

60. Do you think the lessons from capital market history will hold for each year in the future? That is, as an example, if you buy small stocks will your investment always outperform U.S. Treasury bonds?

The student should realize that we are working with averages, so they should not expect riskier assets to always outperform less risky assets. The student should explain somewhere in their answer that this gets to the heart of what risk is. That is, the reason you expect to earn a higher return over the long haul is that your variability in price from year to year can be significant.

Topic: EFFICIENT MARKETS
Type: ESSAYS

61. Suppose your cousin invests in the stock market and doubles her money in a single year while the market, on average, earned a return of only about 15%. Is your cousin's performance a violation of market efficiency?

No, market efficiency does not preclude investors from "beating the market." It is entirely possible to earn higher returns than the market at times. However, if your cousin is able to do so consistently, then there would certainly be some doubt cast upon market efficiency.

Topic: MARKET EFFICIENCY
Type: ESSAYS

62. Why should a financial decision maker such as a corporate treasurer or CFO be concerned with market efficiency?

Good answers to this question might indicate that market efficiency is a necessary condition for the "maximize shareholder wealth" rule. Unless we are confident that the market price is an economically meaningful number, seeking to maximize it is silly. Similarly, students should recognize that there is a very strong link between managerial decisions and the value of the firm, as reflected in security prices. Finally, as a preview of the cost of capital discussion in later chapters, instructors might point out that market efficiency ensures that the required returns on new securities will be directly related to the risk-return profile of the firm and, therefore, to managerial actions.

Topic: MARKET EFFICIENCY
Type: ESSAYS