Efficient Market Hypothesis (EMH) Definition

By JUSTIN KUEPPER | Updated Feb 19, 2019

What is the Efficient Market Hypothesis (EMH)?

The Efficient Market Hypothesis, or EMH, is an investment theory whereby share prices reflect all information and consistent alpha generation is impossible. Theoretically, neither technical nor fundamental analysis can produce risk-adjusted excess returns, or alpha, consistently and only inside information can result in outsized risk-adjusted returns.

According to the EMH, stocks always trade at their fair value on stock exchanges, making it impossible for investors to either purchase undervalued stocks or sell stocks for inflated prices.

As such, it should be impossible to outperform the overall market through expert stock

Efficient Market Hypothesis

The Efficient Market Hypothesis Explained

Although it is a cornerstone of modern financial theory, the EMH is highly controversial and often disputed. Believers argue it is pointless to search for undervalued stocks or to try to predict trends in the market through either fundamental or technical analysis.

While academics point to a large body of evidence in support of EMH, an equal amount of dissension also exists. For example, investors such as Warren Buffett have consistently beaten the market over long periods of time, which by definition is impossible according to the EMH. Detractors of the EMH also point to events such as the 1987 stock market crash, when the Dow Jones Industrial Average (DJIA) fell by over 20 percent in a single day, as evidence that stock prices can seriously deviate from their fair values.

Real World Implications for Investors

Proponents of the Efficient Market Hypothesis conclude that, because of the randomness of the market, investors could do better by investing in a low-cost, passive portfolio.

Data compiled by Morningstar Inc., in its June 2015 Active/Passive Barometer study, supports others, investors would have fared better by investing in low-cost index funds or ETFs.

While a percentage of active managers do outperform passive funds at some point, the challenge for investors is being able to identify which ones will do so over the long-term. Less than 25 percent of the top-performing active managers are able to consistently outperform their passive manager counterparts over time.

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