Question #1 of 38

Question ID: 1458163

Hume Inc. announces fourth quarter earnings per share of $1.20, which is 15% higher than last year. Hume's earnings are equal to the consensus analyst forecast for the quarter. Assuming markets are efficient, the announcement will *most likely* cause the price of Hume's stock to:

A) decrease.

B) increase.

C) remain the same.

Explanation

An efficient capital market would price Hume's stock based on the expectation for earnings per share. Since actual earnings equal expected earnings, the stock price should not change as a result of the announcement.

(Module 38.1, LOS 38.a)

Question #2 of 38

Question ID: 1458198

Tom Edwin, CFA, states, "Individuals exhibit biases, such as loss aversion and herding, that result in observed pricing anomalies in financial markets. However, a strategy based on exploiting these anomalies will not earn positive abnormal returns over time." With regard to the efficient markets and behavioral finance views of market pricing, Edwin's statement is *most likely* consistent with:

A) neither behavioral finance nor informationally efficient markets.

B) behavioral finance, but not informationally efficient markets.

C) both behavioral finance and informationally efficient markets.

Explanation

Edwin's statement is consistent with both behavioral finance and informationally efficient markets. While behavioral biases that cause individuals to act irrationally can cause assets to be mispriced, markets can still be considered efficient if asset mispricing cannot consistently be exploited to earn positive risk-adjusted returns on average over time.

(Module 38.1, LOS 38.g)

Question #3 of 38

Question ID: 1462886

The weak form of the efficient market hypothesis (EMH) implies that:

A) investors cannot achieve abnormal returns, on average, using technical analysis, after adjusting for transaction costs and taxes. ✓

B) insiders, such as specialists and corporate board members, cannot achieve abnormal returns on average. ✗

C) no one can achieve abnormal returns using market information. ✗

Explanation

The weak form of the EMH implies that an investor cannot earn positive abnormal returns on average using technical analysis (market information), after adjusting for transaction costs and taxes. Evidence has shown that insiders can achieve positive abnormal returns on average, but this relates to the strong form of the EMH.

(Module 38.1, LOS 38.e)

Question #4 of 38

Question ID: 1458172

The strong-form efficient market hypothesis (EMH) asserts that stock prices fully reflect which of the following types of information?

A) Market. ✗

B) Public and private. ✓

C) Public, private, and future. ✗

Explanation

The strong-form EMH assumes that stock prices fully reflect all information from public and private sources.

(Module 38.1, LOS 38.d)

Question #5 of 38

Question ID: 1458170

Which of the following statements on the forms of the efficient market hypothesis (EMH) is *least* accurate?

A) The weak-form EMH assumes market prices reflect current public market information and expectations.

B) The strong-form EMH assumes market prices reflect all public and private information.

C) The semi-strong form EMH assumes market prices reflect all public information.

Explanation

The weak-form EMH assumes the price of a security reflects all historical price and volume information.

The other statements are true. The semi-strong form EMH assumes market prices reflect all public information. The strong-form EMH states that stock prices reflect all types of information: market, non-public market, and private.

(Module 38.1, LOS 38.d)

Question #6 of 38

Question ID: 1458171

The statement, "Stock prices fully reflect all information from public and private sources," can be attributed to which form of the efficient market hypothesis (EMH)?

A) Weak-form EMH.

B) Semistrong-form EMH.

C) Strong-form EMH.

Explanation

This is the definition of the strong-form EMH. Private sources include insider information, such as persons holding monopolistic access to information relevant to the formation of prices.

(Module 38.1, LOS 38.d)

Question #7 of 38

Question ID: 1458177

Which of the following statements about the efficient market hypothesis (EMH) is *most accurate*?

A) The weak form of the EMH maintains that current security prices fully reflect all past information.

B) The semistrong form of the EMH states that current security prices fully reflect all public and nonpublic information, both market and nonmarket.

C) The strong form of the EMH implies that no group of investors should be able to consistently achieve positive abnormal returns.

Explanation

If the strong form of the EMH holds, no group of investors should be able to achieve positive abnormal returns consistently. The weak form addresses only past price and trading volume information, not all information. The semistrong form of the EMH does not assume that current security prices reflect nonpublic information.

(Module 38.1, LOS 38.d)

Question #8 of 38

Question ID: 1458181

Under the efficient market hypothesis (EMH), the major effort of the portfolio manager should be to:

A) achieve complete diversification of the portfolio.

B) follow a strict buy and hold strategy.

C) minimize systematic risk in the portfolio.

Explanation

In an efficient market, portfolio managers must create and maintain the appropriate mix of assets to meet their client's needs. The portfolio should be diversified to eliminate unsystematic risk. The appropriate systematic risk will depend on the clients risk tolerance and return requirement. Over time the needs of the client and environment will justify changes to the portfolio. The manager should also try to minimize transaction costs and at least try to match the performance of a benchmark.

(Module 38.1, LOS 38.e)

Question #9 of 38

Question ID: 1458179

If the efficient markets hypothesis is true, portfolio managers should do all of the following EXCEPT:

A) Minimize transaction costs.

B) Spend more time working on security selection.

C) Work more with clients to better quantify their risk preferences.

Explanation

In an efficient market all stocks are properly priced and reflect all publicly available information. Therefore, individual selection of stocks is not important the only thing that is relevant is the portfolio's beta.

(Module 38.1, LOS 38.e)

Question #10 of 38

Question ID: 1458192

If the momentum effect persists over time, it would provide evidence against which of the following forms of market efficiency?

A) Weak form only.

B) Both weak form and semistrong form.

C) Semistrong form only.

Explanation

The momentum effect suggests it is possible to earn abnormal returns using market data. All three forms of market efficiency (weak form, semistrong form, and strong form) assume that market prices fully reflect market data.

(Module 38.1, LOS 38.f)

Question #11 of 38

Question ID: 1458168

A market's efficiency is *most likely* to decrease by:

A) substantial analyst coverage of exchange-listed companies.

B) a ban on short selling.

C) high volumes of trading activity.

Explanation

Short selling helps to prevent market prices from becoming overvalued, while limiting short selling has the opposite effect. More analyst coverage and more liquidity (high trading volume) contribute to market efficiency.

(Module 38.1, LOS 38.c)

Question #12 of 38

Question ID: 1458189

The opportunity to take advantage of the downward pressure on stock prices that result from end-of-the-year tax selling is known as the:

A) January anomaly. ✓

B) end-of-the-year anomaly. ✗

C) end-of-the-year effect. ✗

Explanation

The January Anomaly is most likely the result of tax induced trading at year end. An investor can profit by buying stocks in December and selling them during the first week in January.

(Module 38.1, LOS 38.f)

Question #13 of 38

Question ID: 1458183

Which of the following statements *least likely* describes the role of a portfolio manager in perfectly efficient markets? Portfolio managers should:

A) construct diversified portfolios that include international securities to eliminate unsystematic risk. ✗

B) quantify client's risk tolerance, communicate portfolio policies and strategies, and maintain a strict buy and hold policy avoiding any changes in the portfolio to minimize transaction costs. ✓

C) construct a portfolio that includes financial and real assets. ✗

Explanation

A portfolio manager should quantify each client's risk tolerance and communicate portfolio policies and strategies. However, portfolio managers should monitor client's needs and changing circumstances and make appropriate changes to the portfolio. Adhering to a strict buy and hold policy would not be in the client's best interest. Portfolios need to be rebalanced and changed to meet client's changing needs.

(Module 38.1, LOS 38.e)

Question #14 of 38

Question ID: 1458190

Which of the following would provide evidence against the semistrong form of the efficient market theory?

A) All investors have learned to exploit signals related to future performance. ✗

B) Low P/E stocks tend to have positive abnormal returns over the long run. ✓

C) Trend analysis is worthless in determining stock prices. ✗

Explanation

P/E information is publicly available information and therefore this test relates to the semistrong-form EMH. Trend analysis is based on historical information and therefore relates to the weak-form EMH. In an efficient market one would expect 50% of pension fund managers to do better than average and 50% of pension fund managers to do worse than average. If all investors exploit the same information no excess returns are possible.

(Module 38.1, LOS 38.f)

Question #15 of 38

Question ID: 1458180

Which of the following statements concerning market efficiency is *least* accurate?

A) Market efficiency assumes that individual market participants correctly estimate asset prices. ✓

B) Tests of the semi-strong form of the EMH require that security returns be risk-adjusted using a market model. ✗

C) If weak-form market efficiency holds, technical analysis cannot be used to earn abnormal returns over the long-run. ✗

Explanation

Market efficiency does not assume that individual market participants correctly estimate asset prices, but does assume that their estimates are unbiased. That is, some agents will over-estimate and some will under-estimate, but they will be correct, on average.

(Module 38.1, LOS 38.e)

Question #16 of 38

Question ID: 1458166

The value of an asset that a rational investor with full knowledge about the asset's characteristics would willingly pay is *best* described as the asset's:

A) intrinsic value.

B) market value.

C) theoretical value.

Explanation

Intrinsic value is the price a rational investor with full knowledge about an asset's characteristics would willingly pay for the asset.

(Module 38.1, LOS 38.b)

Question #17 of 38

Question ID: 1462887

Behavioral finance theory suggests that investors tend to:

A) mimic the actions of better-informed investors.

B) underestimate their ability to analyze security information.

C) be more risk averse with respect to gains than with respect to losses.

Explanation

Mimicking the actions of better-informed investors is an example of herding behavior. Behavioral finance suggests investors are more risk averse with respect to losses than gains and tend to overestimate their ability to analyze security information.

(Module 38.1, LOS 38.g)

Question #18 of 38

Question ID: 1458195

Investor overreaction that has been documented in securities markets is *most likely* attributable to investors exhibiting:

A) conservatism.

B) loss aversion.

C) risk aversion.

Explanation

Loss aversion refers to the tendency for investors to dislike downside risks more than upside risks creating asymmetrical risk preferences. This dislike of losses may be a cause of investor overreaction. The standard economic notion of risk aversion assumes symmetric risk preferences. Conservatism is the behavioral bias whereby investors react slowly to new information and is unlikely to cause overreaction.

(Module 38.1, LOS 38.g)

Question #19 of 38

Question ID: 1458191

Which of the following statements *best* describes the overreaction effect?

A) High returns over a one-year period are followed by high returns over the following year.

B) High returns over a one-year period are followed by low returns over the following three years.

C) Low returns over a three-year period are followed by high returns over the following three years.

Explanation

The overreaction effect refers to stocks with poor returns over three to five-year periods that had higher subsequent performance than stocks with high returns in the prior period. The result is attributed to overreaction in stock prices that reverses over longer periods of time. Stocks with high previous short-term returns that have high subsequent returns show a momentum effect.

(Module 38.1, LOS 38.f)

Question #20 of 38

Question ID: 1458186

Octagon Advisors believes that the market is semi-strong efficient. The firm's portfolio managers *most likely* will use:

A) passive portfolio management strategies.

B) an enhanced indexing strategy that relies on trading patterns.

C) active portfolio management strategies.

Explanation

If the market is semi-strong efficient, portfolio managers should use passive management because neither technical analysis nor fundamental analysis will generate positive abnormal returns on average over time.

(Module 38.1, LOS 38.e)

Question #21 of 38

Question ID: 1458182

In a perfectly efficient market, portfolio managers should do all of the following EXCEPT:

A) diversify to eliminate systematic risk.

B) monitor their client's needs and circumstances.

C) quantify their risk and return needs within the bounds of the client's liquidity, income, time horizon, legal, and regulatory constraints.

Explanation

Portfolio managers cannot eliminate systematic risk (i.e., market risk) thru the use of diversification. Portfolio managers should try to eliminate unsystematic portfolio risk.

(Module 38.1, LOS 38.e)

Question #22 of 38

Question ID: 1462885

If stock markets are semistrong-form efficient, a portfolio manager is *least likely* to create value for investors by:

A) monitoring clients' needs and circumstances.

B) analyzing financial statements to select undervalued stocks.

C) allocating invested funds among asset classes.

Explanation

Semistrong-form market efficiency implies that fundamental analysis of publicly available information will not generate abnormal returns on average. Portfolio managers should help quantify a client's risk tolerances and return needs, offer portfolio policies and strategies to meet these needs, and construct a portfolio by allocating funds to appropriate asset classes. Portfolio managers can also create value by diversifying their clients' portfolios globally to reduce risk, monitoring and evaluating changing capital market conditions, monitoring their clients' needs and circumstances, and rebalancing their clients' portfolios when necessary.

(Module 38.1, LOS 38.e)

Question #23 of 38

Question ID: 1458194

In behavioral finance theory, loss aversion is *most accurately* defined as asserting that for gains and losses of equal amounts, investors:

A) like gains more than they dislike losses.

B) dislike for losses and like for gains are proportionate.

C) dislike losses more than they like gains.

Explanation

Behavioral finance proposes that investors are loss averse. Loss aversion means investors dislike losses more than they like gains of the same amount.

(Module 38.1, LOS 38.g)

Question #24 of 38

Question ID: 1462884

An analyst with Guffman Investments has developed a stock selection model based on earnings announcements made by companies with high P/E stocks. The model predicts that investing in companies with P/E ratios twice that of their industry average that make positive earnings announcements will generate significant excess return. If the analyst has consistently made superior risk-adjusted returns using this strategy, which form of the efficient market hypothesis has been violated?

A) Semistrong and strong forms only.

B) Strong, semistrong, and weak forms.

C) Weak form only.

Explanation

The semistrong form of EMH states that security prices rapidly adjust to reflect all publicly available information. If the analyst can use his model, which is based on publicly available information, to earn above average returns, the semistrong form of the EMH has been violated. If the semistrong form of EMH is violated, the strong form of EMH is also violated.

(Module 38.1, LOS 38.e)

Question #25 of 38

Question ID: 1458175

The semi-strong form of the efficient market hypothesis (EMH) is *most accurately* described as asserting that security prices fully reflect all:

A) relevant information, including information not publicly available.

B) historical price and volume information.

C) publicly available information.

Explanation

The semi-strong form of the EMH asserts that security prices fully reflect all publicly available information. This includes all historical price and volume information, which the weak form of the EMH asserts is fully reflected in security prices. The strong form of the EMH asserts that security prices fully reflect all public and private information.

(Module 38.1, LOS 38.d)

Question #26 of 38

Question ID: 1458176

Which of the following forms of the EMH assumes that no group of investors has monopolistic access to relevant information?

A) Strong-form.

B) Both weak and semistrong form.

C) Weak-form.

Explanation

According to the strong-form EMH, security prices reflect all information, which includes the privately available (monopolistic) information.

(Module 38.1, LOS 38.d)

Question #27 of 38

Question ID: 1458173

The semi-strong form of efficient market hypothesis (EMH) asserts that:

A) all public information is already reflected in security prices. ✓

B) both public and private information is already incorporated into security prices. ✗

C) only past market information is reflected in security prices. ✗

Explanation

Semi-strong EMH states that publicly available information cannot be used to consistently beat the market performance.

(Module 38.1, LOS 38.d)

Question #28 of 38

Question ID: 1458165

A stock is said to be undervalued if its market price is:

A) less than its book value. ✗

B) greater than its intrinsic value. ✗

C) less than its intrinsic value. ✓

Explanation

A security with a market price less than its intrinsic value is undervalued.

(Module 38.1, LOS 38.b)

Question #29 of 38

Question ID: 1458161

An efficient capital market:

A) fully reflects all of the information currently available about a given security, excluding risk.

B) does not fully reflect all of the information currently available about a given security, including risk.

C) fully reflects all of the information currently available about a given security, including risk.

Explanation

An efficient capital market fully reflects all of the information currently available about a given security, including risk.

(Module 38.1, LOS 38.a)

Question #30 of 38

Question ID: 1458162

In an informationally efficient market:

A) buying and holding a broad market portfolio is the preferred investment strategy.

B) share prices adjust rapidly when companies announce results in line with expectations.

C) the conditions exist for active investment strategies to achieve superior risk-adjusted returns.

Explanation

If financial markets are informationally efficient, active investment strategies cannot consistently achieve risk-adjusted returns superior to holding a passively managed index portfolio. In addition, a passive investment strategy has lower transactions costs than an active management strategy. Share prices should not adjust when a company announces results in line with expectations in an informationally efficient market, because the market price already reflects the expected results.

(Module 38.1, LOS 38.a)

Question #31 of 38

Question ID: 1458167

Which of the following would be inconsistent with an efficient market?

A) Price adjustments are biased.

B) Price changes are independent.

C) Stock prices adjust rapidly to new information.

Explanation

Market efficiency assumes that investors adjust their estimates of security prices rapidly to reflect their unbiased interpretation of the new information. New information arrives randomly and independently. Therefore, price changes are independent.

(Module 38.1, LOS 38.c)

Question #32 of 38

Question ID: 1458174

Which of the following forms of the EMH assumes that no group of investors has monopolistic access to relevant information?

A) Strong-form.

B) Weak-form.

C) Both weak and semistrong form.

Explanation

The strong-form EMH assumes that stock prices fully reflect all information from public and private sources. In addition, no group of investors has monopolistic access to information relevant to the formation of prices.

(Module 38.1, LOS 38.d)

Question #33 of 38

Question ID: 1458196

An investor who is more risk averse with respect to potential negative outcomes than potential positive outcomes *most likely* exhibits which behavioral finance characteristic?

A) Loss aversion.

B) Conservatism.

C) Mental accounting.

Explanation

Loss aversion is exhibited by an investor who dislikes a loss more than he likes an equal gain. That is, the investor's risk preferences are asymmetric. Mental accounting refers to mentally classifying investments in separate accounts rather than considering them from a portfolio perspective. In behavioral finance, conservatism refers to a tendency to maintain one's prior views even in the presence of new information.

(Module 38.1, LOS 38.g)

Question #34 of 38

Question ID: 1458164

The measure of an asset's value that can *most likely* be determined without estimation is its:

A) fundamental value.

B) intrinsic value.

C) market value.

Explanation

The current price of a traded asset is its market value. An asset's intrinsic or fundamental value is the price a rational investor with complete information about the asset would pay for it.

(Module 38.1, LOS 38.b)

Question #35 of 38

Question ID: 1458185

David Farrington is an analyst at Farrington Capital Management. He is aware that many people believe that the capital markets are fully efficient. However, he is not convinced and would like to disprove this claim. Which of the following statements would support Farrington in his effort to demonstrate the limitations to fully efficient markets?

A) Processing new information entails costs and takes at least some time, so security prices are not always immediately affected.

B) Stock prices adjust to their new efficient levels within hours of the release of new information.

C) Technical analysis has been rendered useless by many academics who have shown that analyzing market trends, past volume and trading data will not lead to abnormal returns.

Explanation

If market prices are efficient there are no returns to the time and effort spent on fundamental analysis. But if no time and effort is spent on fundamental analysis there is no process for making market prices efficient. To resolve this apparent conundrum one can look to the time lag between the release of new value-relevant information and the adjustment of market prices to their new efficient levels. Processing new information entails costs and takes at least some time, which is a limitation of fully efficient markets.

(Module 38.1, LOS 38.e)

Question #36 of 38

Question ID: 1458193

The idea that uninformed traders, when faced with unclear information, observe the actions of informed traders to make decisions, is referred to as:

A) herding behavior.

B) information cascades.

C) narrow framing.

Explanation

"Information cascades" refers to uninformed traders watching the actions of informed traders when making investment decisions. Herding behavior is when trading occurs in clusters, not necessarily driven by information. Narrow framing refers to investors viewing events in isolation.

(Module 38.1, LOS 38.g)

Question #37 of 38

Question ID: 1458169

An increase in which of the following factors would *most likely* improve a market's efficiency?

A) Restrictions on short selling.

B) Number of participants.

C) Bid-ask spreads.

Explanation

As the number of market participants increases, the speed at which markets adjust to new information is likely to increase. Restrictions on short selling limit the ability of arbitrage to correct pricing anomalies. High bid-ask spreads increase transaction costs and decrease efficiency.

(Module 38.1, LOS 38.c)

Question #38 of 38

Question ID: 1458184

Which of the following is a limitation to fully efficient markets?

A) The gains to be earned by information trading can be less than the transaction costs the trading would entail.

B) Information is always quickly disseminated and fully embedded in a security's prices.

C) There are no limitations to fully efficient markets because the trading actions of fundamental and technical analysts are continuously keeping prices at their intrinsic value.

Explanation

Market prices that are not precisely efficient can persist if the gains to be made by information trading are less than the transaction costs such trading would entail.

(Module 38.1, LOS 38.e)