



SFB/Transregio 266

ACCOUNTING FOR TRANSPARENCY

Research on Corporate Transparency

Element 12: On the Impossibility of Informationally Efficient Markets

Joachim Gassen

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A reminder: Sufficient conditions for informationally efficient markets

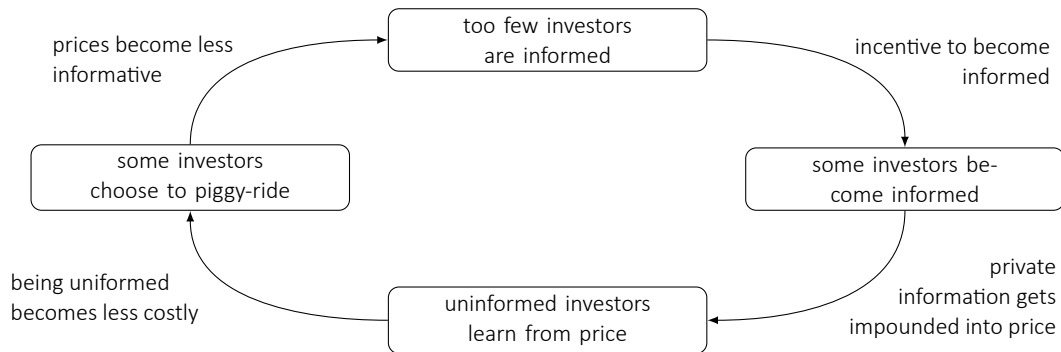
- 1 No trading/transaction costs
- 2 Information is available for all investors at no costs
- 3 Investors are rational and have homogeneous beliefs

Central assumptions:

- Investors possess homogeneous, but incomplete information
- Additional information is obtainable at cost
- Investors behave rationally and, hence, can infer information from prices

This results in a rational expectation equilibrium model and the following information paradox:

- On a strongly efficient market, investors have no incentives to engage in costly information gathering, as prices reflect all publicly available information
- Yet, if investors abstain from trading on information, prices lose quality of reflecting all information
- This results in mispricing and incentives for information-based trading



On the existence of informationally efficient markets

Efficient Markets theorists seem to be aware that costless information is a sufficient condition for prices to fully reflect all available information (see Fama, p. 387); they are not aware that it is a necessary condition.

— Grossman and Stiglitz (1980, AER, p. 404)

- Markets will never be fully informationally efficient
- The more efficient they become, the less incentives market participants have to acquire information
- Market with homogeneous information/beliefs and low information cost tend to be illiquid
- There is constant arrival of new information and constant change in information acquisition cost
- In addition, information acquisition cost varies across market participants
- Thus, there will always be information asymmetry on (capital) markets
- And there will always be an incentive to acquire information and to impound it into prices

Against all this, financial reporting has the objective:

- to increase the level of information (increase information precision) and
- to level the playing field (lower information asymmetry)