Chapter 11

BKM Chapter 11

EMH Three Forms:

Weak, Semi-strong and Strong

Technical Analysis: against which form of EMH

Fundamental Analysis: against which form of EMH

Exception is if investor has unique perspective derived from analysis, which the general public does not have

Then active management may bring some benefits

But the benefits are small and trading costs money. Thus only large portfolio of investment could justify the active management.

Small investors can participate in mutual funds or be passive.

What’s event study: measure of price change from a particular event; Two problems associated with event studies: other factors may impact and information leaked before actual event.

Leaking of information: look at Cumulative Abnormal Price Change before actual event

Difficult to conclude EMH doesn’t work:

* Magnitude: only a few points improvement is too small compared to normal volatility, hard to prove it is from active management.
* Selection Bias: methods work but public does not know. This may imply EMH hold, but not if considering at these strategies.
* Lucky Event Issue: if people earn excess return, does not disprove EMH, maybe just by chance.

Tests:

Weak form :

* Return over short horizon proves EMH holds—cannot make profit by investigating historical price.
* Long term disproves EMH—negative correlation

Semi-strong Test:

EMH Anomalies:

Small-firm-in-January, Neglected Firm, Book-to-Market Ratio, Earning call drift

Debate not settled on whether EMH holds. Could be fundamental risks

Role of portfolio management: IMPORTANT

Diversification, unique risk profile of investor, tax consideration

Semi Strong EMH:

Page 142 on Goldfarb says:

*P/EBefore summarizing the main points, note though that in these examples it is necessary to riskadjust*

*the returns and therefore we have to use a model such as CAPM or APT to determine*

*what the risk adjusted returns should have been. But if our risk adjustment is incorrect, it*

*could mistakenly suggest that an excess return exists when in fact it is just a failure of our*

*risk adjustment.*

Excess return may be wrong if we have an incorrect formula of risk adjustment.

Are anomalies proof of EMH or Inefficient Market?

* Can be both ways
  + EMH: Small firm/ low Book to Market effect are indications of other explanatory factors of expected return; CAPM has to be expanded
  + Non-EMH: could be analysts incorrectly predicting based on EMH theory, thus overprice on “good performer” or underprice on “bad performer”. Price eventually reverse when participants realize the error