SFB/Transregio 266

ACCOUNTING FOR TRANSPARENCY

# Research on Corporate Transparency

## Element 12: On the Impossibility of Informationally Efficient Markets

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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

# Grossman and Stiglitz (AER, 1980)

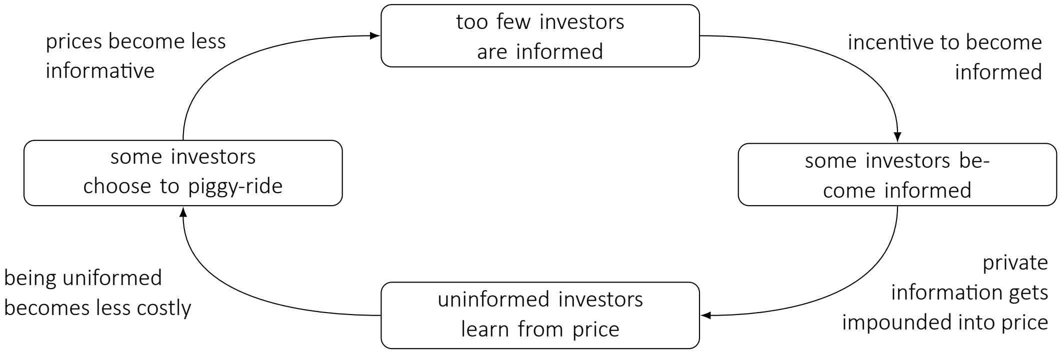
Central assumptions:

- 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

# Intuition


too few investors are informed
incentive to become informed
some investors be- come informed
private information gets impounded into price
uninformed investors learn from price
being uniformed becomes less costly
some investors choose to piggy-ride
prices become less informative

> 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)

# Real-life takeaway

- 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)