

Corporate finance, Stocks, Efficient market hypothesis, practice exam problems

(The attached PDF file has better formatting.)

*Question 1.1: Efficient Market Hypothesis

The efficient market hypothesis has weak, semi-strong, and strong forms. Which of the following statements is an implication of the *strong form* of the efficient market hypothesis?

- A. Market price reflects *all* information.
- B. Prices adjust *slowly* over time to incorporate past stock price data.
- C. *All* actively managed portfolios have the same *actual* return.
- D. The CAPM beta is the *only item* that affects actual stock returns.
- E. Stocks with the same standard deviation of *total* return have the same expected return.

Answer 1.1: A

Statement A is true for *only* the strong form of the efficient market hypothesis. The other four statements are false for all forms of the efficient market hypothesis.

Statement A: The strong form of the efficient market hypothesis says that *all* information is immediately incorporated into the stock price. The semi-strong form says only *public* information is immediately incorporated into the stock price.

Statement B: All three forms of the efficient market hypothesis say that prices adjust *quickly*, not slowly, to incorporate past stock price data.

Statements C and D: *Actual* returns are affected by numerous stochastic factors.

Statement E: Only the standard deviation of *systematic return* affects the expected return. The standard deviation stemming from unique risk is diversified by investors and does not affect the expected return.

*Question 1.2: Efficient Market Hypotheses

David believes that corporate insiders earn large profits by trading on information that other investors do not have. Jon (Jonathan) believes that the profits from insider trading are small. David espouses one form of the efficient market hypothesis and Jon espouses another form. Which of the following is the most likely?

- A. David espouses the weak form; Jon espouses the semi-strong or strong form.
- B. David espouses the weak or semi-strong form; Jon espouses the strong form.
- C. Jon espouses the weak form; David espouses the semi-strong or strong form.
- D. Jon espouses the weak or semi-strong form; David espouses the strong form.
- E. Jon's and David's views are not related to the form of the efficient market hypothesis.

Answer 1.2: B

Insider information is not public. David and Jonathan argue whether non-public information is immediately incorporated into the stock price.

The strong form of the efficient market hypothesis says that all information is immediately incorporated into the stock price. The semi-strong form says only *public* information is immediately incorporated into the stock price.

