## **CHAPTER 11**

**Efficient Markets and Behavioral Finance**

## **Quiz Questions**

4. True or False?

a. Financing decisions are less easily reversed than investment decisions.

b. Tests have shown that there is almost perfect negative correlation between successive price changes.

c. The semi-strong form of the efficient-market hypothesis states that prices reflect all publicly available information.

d. In efficient markets the expected return on each stock is the same.

6. True or False?

a. Analysis by security analysts and investors helps keep markets efficient.

b. Psychologists have found that, once people have suffered a loss, they are

more relaxed about the possibility of incurring further losses.

c. Psychologists have observed that people tend to regard recent events as

representative of what might happen in the future.

d. If the efficient –market hypothesis is correct, managers will not be able to

increase stock prices by creative accounting that boosts reported earnings.

7. Geothermal Corporation has just received good news: its earnings increased by 20% from last year’s value. Most investors are anticipating an increase of 25%. Will Geothermal’s stock price increase or decrease when the announcement is made?

8. Here again are the six lessons of market efficiency. For each lesson give an example showing the lesson’s relevance to financial managers.

a. Markets have no memory.

b. Trust market prices.

c. Read the entrails

d. There are no financial illusions.

e. The do-it-yourself alternative.

f. Seen one stock, seen them all.

## **Practice Questions**

9. How would you respond to the following comments?

a. “Efficient market, my eye! I know lots of investors who do crazy things.”

b. “Efficient market? Balderdash! I know at least a dozen people who have made

a bundle in the stock market.”

c. “The trouble with the efficient-market theory is that it ignores investors’

psychology.”

d. “Despite all the limitations, the best guide to a company’s value is its written-

down book value. It is much more stable than market value, which depends

on temporary fashions.”

10. Respond to the following comments:

a. “The random-walk theory, with its implication that investing in stocks is like

playing roulette, is a powerful indictment of our capital markets.”

b. “If everyone believes you can make money by charting stock prices, then

price changes won’t be random.”

c. “The random-walk theory implies that events are random, but many events

are not random. If it rains today, there’s a fair bet that it will rain again

tomorrow.”

11. Which of the following observations *appear* to indicate market inefficiency? Explain whether the observation appears to contradict the weak, semi-strong, or strong from of the efficient-market hypothesis.

a. Tax-exempt municipal bonds offer lower pretax returns than taxable

government bonds.

b. Managers make superior returns on their purchases of their company’s stock.

c. There is a positive relationship between the return on the market in one

quarter and the change in aggregate profits in the next quarter.

d. There is disputed evidence that stocks that have appreciated unusually in the

recent past continue to do so in the future.

e. The stock of an acquired firm tends to appreciate in the period before the

merger announcement.

f. Stocks of companies with unexpectedly high earnings *appear* to offer high

returns for several months after the earnings announcement.

g. Very risky stocks on average give higher returns than safe stocks.

14. “If the efficient-market hypothesis is true, the pension fund manager might as well

select a portfolio with a pin.” Explain why this is not so.

16. What does the efficient-market hypothesis have to say about these two statements?

a. “I notice that short-term interest rates are about 1% below long-term rates. We

should borrow short-term.”

b. “I notice that interest rates in Japan are lower than rates in the United States.

We would do better to borrow Japanese yen rather than U.S. dollars.”