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A THEORETICAL FRAMEWORK ON EFFICIENT MARKET THEORY

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ABSTRACT

The Efficient Market theory has always been a popular topic for discussion among Stock Market Researchers. It suggests that nobody can predict market, return is fully depending on information which are uncertain, it deals with one of the most fundamental and exiting issues in finance, financial market always behave randomly that is why it is also called random walk theory. The present paper discusses on the theoretical background of efficient market theory or efficient market Hypothesis.

KEYWORDS

efficiency, random walk, unpredictable, anomaly.

1. MARKET EFFICIENCY

Investors and academicians has always been attracted from capital market specially stock. Everybody who invest in market want to outperform in the market. Academicians want to predict it in order to test the effectiveness of their predictive models. In fact, financial markets put a great challenge before the researchers interested in the development of predictive models. Not only financial economists, but researchers from other streams including statistics, mathematics, physics, psychology and social sciences, leveraged with the expertise of their respective domains, have attempted to build predictive models for stock prices. But all of these efforts seem to yield little success. Why are the prices of financial assets unpredictable? The efficient market hypothesis provides the answer to this question.

The financial market has influence by money along with information there in. The prices of financial assets at a point of time reflect the expectations of investors which are shaped mainly by the available information. Accuracy and the quickness in which market translated the expectation into prices are termed as market efficiency. Fama (1970) stated, *'A market in which prices always fully reflect available information is called efficient.'* In an efficient market price rapidly translate in to the available information.

Here the term market efficiency is used in context to the 'informational efficiency' rather than the 'operational efficiency' and the 'allocative efficiency'. The concept of operational efficiency is basically related to the efficiency of the market microstructure and is influenced by the factors as time taken to execute the order and the number of bad deliveries. The operationally efficient market keeps the transaction costs at minimum. On the other hand, the concept of 'allocative efficiency' refers to the application of basic concept of 'Pareto-efficiency' of economics in the field of financial markets. Financial markets are efficient in Pareto sense if they allocate the capital to different products in an efficient way and any further reallocation of capital cannot increase the national output.

2. EFFICIENT MARKET THEORY

The efficient market theory or efficient market hypothesis (EMH) says that the stock market prices or returns are unpredictable and do not follows any regular pattern so it is impossible to "beat the market" or outperform in market. According to the EMH theory security prices immediately and fully reflect all available relevant information.

The EMH theory suggests that the asset prices are determined by the demand and supply in the competitive market with rational investors. Rational investors gather information very rapidly and immediately incorporate this information into stock prices. Only new information, i.e. news, cause change in prices but the news, by definition, is unpredictable; therefore, stock market which is immediately influenced by the news is also unpredictable.

According to EMH theory neither technical (study of past stock prices in an attempt to predict future prices) nor fundamental analysis (financial analysis such as industry analysis, company analysis, asset valuation etc.) can help the investor to select "under-valued stock". Past price contain no useful information and cannot predict the

future change, today's price is totally independent from past price so it is waste of time to analyze past return and on the basis of result attempt or expect to make profit from market.

If we discuss about historical background of EMH theory, efficient market is as old as stock market itself but the hypothesis was first expressed by Louis Bachelier, a French mathematician in 1900. In his dissertation, "*The Theory of speculation*" has suggested that price fluctuation is random and do not follow any regular pattern. In 1933 Cowles, an American Economists and businessman attempted to investigate the predictability of stock price, he analyzed the performance of market professionals and suggested that stock market is unforecastable even professional investors are unable to outperform in the market. Further in 1934, Holbrook Working supported the EMH theory by showing his empirical result that in ideal market, prices follow random differences and it is impossible to predict price changes successfully.

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In 1956, Bachelier's name reappeared in finance, Paul Samuelsson took interest in Bachelier's work and he circulated this among economists. Samulson was the first who provided the formal economic argument for efficient market; his contribution was summarized by the title of his article "*Proof that Properly Anticipated Prices Fluctuate Randomly*". Prior to Samuelsson's work it was believed that random fluctuation of asset prices is a reflection of market inefficiency. Economists used to look at such observations at great disbelieve (See Kendall 1953). According to them, if prices are determined by the "forces of supply and demand", then price changes should move in particular direction towards market clearing and not randomly. Samuelsson argued that the random nature of changes in asset prices is not a reflection of inefficient functioning of financial markets rather it is a reflection of their efficiency. In an efficient market, prices reflect all the available information at a particular point of time; prices change only when new information (news) arrives in the market. Since, news by definition is unpredictable and random in nature; hence, it causes random changes in price. Mandelbrot (1966) also supported this view. He argued that if markets are working properly, then all public (and, in some versions, private) information regarding an asset will be channeled immediately into its price. If price changes seem random and thus unfore-castable it is because investors are doing their jobs: all arbitrage opportunities have *already* been exploited to the extent to which they can be.

In 1965, the term *"Efficient Markey"* was defined by Fama at first time, Fama explained how the theory of EMH challenges to both technical and financial analysts. Some important definitions related to efficient market hypothesis are as follow:

Fama (1965) defines EMH theory *"...an "efficient" market for securities, that is, a market where, given the available information, actual prices at every point in time represent very good estimates of intrinsic values."*

Jensen (1978) defines "*A market is efficient with respect to information set* θ *if it is impossible to make economic profits by trading on the basis of information set* θ *"*.

Malkiel (1992) provides a closely related definition of efficient market hypothesis as "*A capital market is said to be efficient if it fully and correctly reflects all relevant information in determining security prices. Formally, the market is said to be efficient with respect to some information set, φ, if security prices would be unaffected by revealing that information to all participants. Moreover, efficiency with respect to information set, φ, implies that it is impossible to make economic profits by trading on the basis of φ".*

Fama (1998): *"…market efficiency (the hypothesis that prices fully reflect available information)..." … the simple market efficiency story; that is, the expected value of abnormal returns is zero, but chance generates deviations from zero (anomalies) in both directions."*

Timmermann and Granger (2004): *"A market is efficient with respect to the information set, Ωt, search technologies, St, and forecasting models, Mt, if it is impossible to make economic profits by trading on the basis of signals produced from a forecasting model in Mt defined over predictor variables in the information set* Ω_t *and selected using a search technology in St."*

Implications of EMH theory may be pointed out as follows:

- In efficient market stock price is always at the "fair" level, a stock price change only when its fair value changes.
- The market is efficient if the reaction of market prices to new information is immediate and unbiased.
- Stock prices immediately react on the news.
- Stock price changes are unpredictable because no one knows tomorrow's news.
- Stock prices follow random walk, if price of today goes up nobody can tell what would be the price of tomorrow.
- It is impossible for investors to consistently outperform in the market.

2.1 FORMS OF EFFICIENT MARKET THEORY

In 1970, Fama classified efficient market hypothesis in three categories according to the level of information reflected in market prices – weak form, semi-strong form and strong form; a summarized description of these different forms of market efficiency is presented below:

2.1.1 WEAK FORM

The weak form efficiency is also popularly known as 'random-walk'. In weak form of market efficiency stock prices reflect by all available trading information which can be derived from the market data such as past price, trading volume etc, so nobody can use information related to past price to identify the undervalued security and make a big profit by them, It implies that no one should be able to outperform the market using something that "everybody else knows". If the markets are efficient in weak from, technical trading rules cannot be used to make profit on a consistent basis. This form of market efficiency is called weak-efficiency because the security prices are the most publicly and easily accessible pieces of information. Although number of empirical studies support weak form of efficient market but there are still numbers of financial researchers are studying the past stock price series and trading volume data in attempt to generate profit. In short weak form of efficient market implies that:

- Stock prices quickly incorporate all past price information which can be derived by trading data (i.e. past prices, volume, short interest).
- Everyone knows the past price movement of market; therefore, nobody can outperform the market on a consistent basis using some trading strategy based on past price trends (as done by technical analysts).
- Prices follow a "random walk" or more precisely an 'exponential random walk'.

2.1.2 SEMI-STRONG FORM

In semi-strong form all publicly available information is incorporated into current stock prices. Publicly available information includes past price information plus company's annual reports (such as financial reports, balance sheet and profit and loss account), company's announcement, macro-economic factors such as (inflation, unemployment etc) and others. Some information (to the extent anticipated in advance) is discounted even before the event is announced and some before the event took place. Such matters like earnings reports, bonus, and rights affect the market even in anticipation before the formal announcements. Semi-strong form implied that share prices adjust to publicly available new information very rapidly and in an unbiased fashion, such that no one should be able to outperform the market using something that "everybody else knows". This indicates that a company's financial statements are of no help in forecasting future price movements and securing high investment returns. Evidences of empirical studies (most of them are based on event-study methodology) broadly support this form of efficiency.

Implications of Semi-Strong form are as follow:

- Market prices incorporate all publicly available information.
- Publicly available information is easily reachable for everybody so no investor can use it to device the strategy which could outperform the market on a consistent basis.
- Share prices adjust to publicly available new information very rapidly and in an unbiased fashion, such that no excess returns can be earned by trading on that information.
- Neither technical analyst nor fundamental analyst will be able to help the investors to outperform in the market.

However, the following factors can impede the market-efficiency in its strong form:

- Information may be relatively difficult and costly to obtain.
- Information may be asymmetrically distributed; some investors may have access to information but others may not have.
- It may be difficult to segregate the information from noise.
- It may be difficult to interpret and to understand the exact implication of information.

2.1.3 STRONG FORM

In strong form of efficiency stock prices quickly reflect all types of information which include public information plus companies inside or private information. Thus, it is the combination of public and private information that is incorporated into current prices. This form implies that even companies management can not make profit from inside information; they cannot take advantage of inside affairs or important decision or strategies to beat the market. According to strong-form market efficiency, inside information is also already incorporated into stock prices, the common rational behind this is unbiased market anticipation that already react in to market before companies strategic decision. Strong form of efficiency is hard to believe in practice except where rules and regulations of law are fully ignored. Studies (Reilly & Brown, 2008) that examined the result of the corporate insiders and stock exchange specialists do not support the strong form of efficient market hypothesis. Empirical evidence has been mixed, but has generally not supported strong forms of the efficient-market hypothesis

Implications of strong form of efficiency is-

- Market prices incorporate all public and private information.
- Nobody can gain abnormal return even those who have inside information.
- This type of market is very hard to believe.

3. EVIDENCE IN FAVOR OF EMH

From past studies by researchers following evidences come out in favor of EMH:

- In general, prices appear to react quickly to new information.
- Fama (1965) found no serial correlation in stock returns (price changes are random).
- Most money managers do not outperform in the market, and those that do **o**utperform in one period do not appear consistently to do so in the next period.
- Most of anomalies disappear quickly.

- Even the strongest anomalies do not produce dependable returns over all time periods.

EMH remained a prominent theory until 90's. By the start of the twenty first century, the monopoly of EMH among other market theories had become far less universal, a number of empirical argument started to attack EMH theory. EMH has been a hot topic for argument among financial researchers. Empirical analysts have consistently found problem with the efficient market hypothesis. Many financial economists and statistician began to believe that stock prices are at least partially predictable because many researchers found in their studies that psychological and behavioral (sentiments and expectations) elements play an important role in determining price of stock in market rather than fundamental factors.

Some empirical evidences which are against the EMH are as follows:

- If the markets are efficient and prices reflect the fundamental value of assets, the prices should not follow the volatile moves as they generally follow. Assets bubbles are crises are difficult to explain in an efficient market. Sudden market crashes as happened on 1992, Black Monday in 1987 are unsolved for the supporters of EMH.
- Researchers have observed statistically significant (although economically quite low) autocorrelations in stock returns. These correlations are mostly positive in short run and negative in long run.
- There are certain systematic patterns (called anomalies) observed by the researchers; which are inconsistent to the EMH.

Grossman and Stiglitz (1971, 1980) suggested that Information are costly, prices cannot perfectly translate into available information so it is very hard for a market to be perfectly efficient, if so investors who have spent resources on obtaining and analyzing they would receive no compensation. LeRoy and Porter in 1981 found that stock markets exhibit 'excess volatility' and they rejected market efficiency. However, there are a number of empirical evidences by researchers that show market inefficiency and reject random walk of security prices *i.e.* (Laffont and Maskin 1990, Lehmann 1990, Jegadeesh 1990), Shiller 2000 etc.).

4. CONCLUSION

However, number of studies have been made outperform in market. Number of anomalies have been find out by researchers to beat the idea of efficient market hypothesis. which indicate market inefficiency (profit opportunities) or in another words inadequacies in the underlying asset-pricing model. But After its documentation and analysis in the academic literature, anomalies often seem to disappear, reverse, or soothe. It raises a question, whether profit opportunities existed in the past, but have since been arbitraged away, or whether the anomalies were simply statistical peculiarity that engrossed the attention of academics and practitioners.

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