

# Capital Market Efficiency

## Questions

---

### Question 1

Define the concept of capital market efficiency. What is meant by the weak, semi-strong and strong forms of market efficiency? How does the concept of market efficiency differ from the concept of capital market *inefficiency*?

### Question 2

In a speech given by the governor of the Reserve Bank of Australia it was implied that interest rates are likely to be lowered in the near future. What would be the *most likely* effect of such a reduction in interest rates on stock prices?

- a. Stock prices would tend to fall following the announcement.
- b. Some prices would tend to rise following the announcement.
- c. Some stock prices would rise while others would fall following the announcement.
- d. There would be little change in stock prices following the announcement.

### Question 3

John Smith states that superior risk-adjusted returns can be earned by buying the common shares of companies that have above-average return on capital and, at the same time, are selling at below-average price-to-earnings ratios. If this is true, the:

- a. Weak form of the efficient market hypothesis would be confirmed.
- b. Semi-strong form of the efficient market hypothesis would be confirmed.
- c. Weak form of the efficient market hypothesis would be violated.
- d. Semi-strong form of the efficient market hypothesis would be violated.

### Question 4

An investor believes the market to be semi-strong form efficient. If her belief is valid, which of the following is most accurate concerning how to select stocks that will produce superior risk-adjusted returns?

- a. Technical analysis is likely to be an inefficient strategy, but fundamental analysis might be effective.
- b. Fundamental analysis is likely to be an ineffective strategy, but technical analysis might be effective.
- c. Technical and fundamental analyses are both likely to be effective strategies.
- d. Technical and fundamental analyses are both likely to be ineffective strategies.

**Question 5**

Mr Smith reads in the Wall Street Journal that Microsoft announced unexpected high earnings three days ago. He calls his broker and asks him to buy 1,000 shares before the price rises on the announcement. This is a violation of which form of the efficient market hypotheses?

- a. Weak form.
- b. Semi-strong form.
- c. Robust form.
- d. Semi-weak form.

**Question 6**

Ms Smith tells a friend that her firm will announce a large mineral deposit discovery in three days. As the rest of the market is unaware of this information, the friend buys shares and becomes wealthy when the price of the stock rises on the day of the announcement. This is a violation of which form of the efficient market hypothesis?

- a. Weak form.
- b. Semi-strong form.
- c. Strong form
- d. Semi-weak form.

**Question 7**

Which of the following statements is *most accurate*?

- a. According to the strong form of the efficient market hypothesis, a broker should expect to earn an abnormally high risk-adjusted return by acting on a tip from the CEO of a company about an upcoming surprise announcement.
- b. According to the semi-strong form of the efficient market hypothesis, trend-following techniques, whether applied to stock price data, stock price and volume data, earnings data, or price-to-earnings ratio data should not lead to abnormally high risk-adjusted returns for the investor.
- c. The strong form of the efficient marker hypothesis is less inclusive than the weak form of the EMH.
- d. According to the efficient market hypothesis, constructing a portfolio of securities whose values exceed their price by a wide margin is the best way to enhance an investor's return-to-risk ratio.

**Question 8**

Ms Smith follows a strategy of buying stocks when the stock price trends are positive. If her strategy is unsuccessful, this is a validation of what form of the efficient market hypothesis (EMH)?

- a. Weak form.
- b. Semi-strong form.
- c. Strong form.
- d. Comprehensive form.

**Question 9**

Mr Smith reads in the Financial Times that ExxonMobil announced unexpectedly high earnings the other day. He calls his broker and asks him to buy 500 shares before the price rises on the announcement. Which form of market efficiency is being violated if he profits from this transaction.

- a. Semi-strong form.
- b. Fragile form.
- c. Weak form.
- d. Insider form.

**Question 10**

Mr Smith, a Vice President at XYZ Petroleum, tells his sister that the company will announce a huge contract in three days. Since this information has not been released to the market, his sister immediately buys shares of XYZ Petroleum and earns huge profit when the news is announced. Which form of market efficiency has been violated?

- a. Weak form.
- b. Semi-strong form.
- c. Strong form.
- d. Private information form.

**Question 11**

GPR announces that earnings per share for the current quarter are \$12.48, which is nearly double what investors and analysts expected. In an efficient market, the price of GPR will:

- a. Change immediately to reflect changes in investor expectations.
- b. Gradually rise over several days as investors assimilate the new information.
- c. First rise, reflecting investor's surprise, and then retreat somewhat as investors assimilate the new information.
- d. Not change at all.