

Program Bachelor of Arts Subject

Economics course code easiest 104.

Course title Financial Economics 2.

Unit 2 valuation

Module name

efficient market theory.

Hello everyone,

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Today I'm going to explain

the efficient market theory.

Outline of the module.

This module will cover meaning and

forms of efficient market theory.

Learning outcome upon completion

of this a module,

students will be able to understand and

analyze the efficient market theory.

Before we begin with the

efficient market theory.

A very important concept which is

associated with the efficient market

theory is the concept of valuation.

So before understanding the

efficient market theory,

let's have a look at what is valuation?

Because this theory is referred in

context of the valuation of common stocks.

Valuation means professionally,

estimating, assessing, determining,

setting the price worth and

value of a thing or an asset.

Now,

since the objective of any

investment is to select an asset

which is worth more than its cost,

it is crucial that we do valuation.

The valuation of common stock

is complex and difficult.

Why is it complex and difficult?

Because the cash flows and maturity

are not fixed in common stock.

Therefore,

there are three valuation approaches

to common stock valuation.

They are the technical approach,

the fundamental approach and

the efficient market approach.

Let's begin with efficient market theory.

According to the efficient market theory.

Share prices fully reflect all the relevant

information that is available and usable.

In other words, share prices fully

reflect the economic value of a share.

The implication of this theory are profound.

The efficient market theory is

associated with the idea of random walk.

So what is this random walk random walk is a

term loosely used in the finance literature

to characterize a price series where

all subsequent price changes represent

random departures from previous price.

In other words, price do not follow

a particular pattern or trend.

The practical implication is that the practical implication of the efficient market theory is that not much time, money, energy needs to be devoted to the analysis of securities.

Fama presented the efficient market theory in terms of a fair game model asserting that investors can be sure that the current market price fully reflects all available information about the security and the expected return.

Based upon this price is consistent with its risk.

Fama has divided the efficient market hypothesis into 3 sub hypothesis.

The first one is weak form hypothesis, the second one is semi strong form hypothesis and the third one is strong form of efficiency.

The first form that is the weak form of efficient market hypothesis,

assumes that the share prices fully reflect all security market information contained in past price movement, which includes rates of return trading volume, other market generated information, block trades, etc.

Because it assumes that current market price reflect all the past returns and any other security market information.

It implies that past rates of return should not have any relationship with future rate of return.

Therefore it is pointless basing trade rules on share price history as the future cannot be predicted in this way.

In other words, you cannot gain from using trading rule that decides whether to buy or sell the security based on the past data.

Moving on to the next form,

the next form is the semi strong  
form efficient market hypothesis.

Now,

this hypothesis encompasses the  
weak form of hypothesis.

Now, according to this hypothesis,  
share price fully reflect all the  
relevant public available information.

So the semi strong form of efficient  
market hypothesis also not only  
includes past price movements but  
also all the public information.

Public information suggests stock prices,  
earnings and dividend announcement  
rights issue.

News about the economy, political news,  
resignation of directors,  
and so on.

The semi strong form of efficient  
market hypothesis implies that  
there is no advantage in analyzing

the publicly available information  
after it has been released because  
the market has absorbed all the  
relevant information in its prices.

Investors,

therefore,

investors who base their decision on any  
important new information after it is public,  
will not derive above average  
risk adjusted profits.

Moving on to the last form of  
efficient market hypothesis,  
the last form of efficient market  
hypothesis is a strong form of  
efficient market hypothesis.

Now, this particular hypothesis assumes  
that the stock price fully reflect all  
information from public and private sources.

So, nobody has the monopolistic access to  
information relevant to the investment.

In other words, no group of investors

should be able to derive above

average risk adjusted returns.

The strong form of efficient

market hypothesis encompasses both

weak as well as the semi strong

form efficient market hypothesis.

In this hypothesis,

the focus is on insider trading.

So what is insider trading?

Insider trading occurs when

few privileged individuals,

for example directors,

are able to trade in shares as they know

more than the normal investors in the market.

In a strong form efficient market,

even insiders are unable to make

abnormal profits and all the

information is cost free and available

to everyone at the same time.

That's all in this

video for further reference,

you can look up to these two books,

.

Thank you.