

Fama's Efficient Capital Markets

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Introduction

A few would argue that the concept of market efficiency is extremely crucial in contemporary financial theory. This is because voluminous research work has been conducted by different scholars who have developed interest on the subject. Various authors such as Rubinstein (1975), Beaver (1981) and Black (1986) define market efficiency differently, but it is the work of Fama (1991) that has caught the attention of the majority. According to Fama (1991), a market is efficient if prices fully reflect all available information. This hypothesis has been in use since 1991 and serves as a guide to approaching market efficiency analysis; that is the use of information to ascertain trading costs.

That said Fama's 1991 market efficiency hypothesis is a modification of 1970's. Fama (1970) suggests that information on market efficiency can be evaluated using a model of equilibrium better known as asset-pricing model that asserts that "information is properly reflected in prices in the context of a pricing model that defines the meaning of properly". Fama (1970) argues that market prices offer precise signals for the allocation of resources.

The Concept of Market Efficiency

Fama (1970) is in strong opposition of the fact that for empirical research to make sense, market efficiency must undergo a joint test with an equilibrium-pricing model. In his perspective, both the asset-pricing and equilibrium-pricing models are not necessary in empirical research. There is more to market efficiency than just carrying out empirical research. There must be scientific approaches to everything; otherwise, investment will have little meaning.

To avoid deliberate ambiguity, the 1970 reviewed places research on market efficiency into 3 types: (1) weak-form tests (How good do past returns foretell the future?), (2) semi-strong-

form tests (How promptly do security prices reflect public information announcements?), and (3) strong-form tests (Do any investors have private information that is not fully reflected in market prices?). The first test carries out forecasts on returns utilizing variables such as rates of interest and dividend yields. It purely tests return predictability. And because equilibrium-pricing and market efficiency cannot be separated, predictability has to include asset-pricing models and all anomalies to come up with a consolidated evaluation. The second and third categories can be combined to form a general approach mechanism to market efficiency. Fama (1991) changed the titles of the second and third categories, but retained their meaning and content. He renamed the combined category to *tests for private information*.

Fama (1991) modernized the concept of market efficiency as defined in his 1970 work lamenting ambiguities about information and trading costs and the joint-hypothesis. This makes market efficiency per se untestable. This calls for the employment of both equilibrium-pricing and asset-pricing models in determining market efficiency. Investors are dying to understand market efficiency to ensure that their monetary and time efforts come to fruition. Without this investment would become riskier and deterring to most (Milionis, 2006).

It is unfortunate that the concept of market efficiency is facing aggression from scholars like DeBondt and Thaler (1985, 1987). Their conclusion was that the New York Stock Exchange (NYSE) stocks termed as the greatest losers over a 3-5 year period realized strong returns compared to the market during the following years. On the other hand, the stocks dubbed greatest winners had weak returns relative to the market in following years. These are the real constraints to market efficiency. DeBondt and Thaler (1985, 1987) did not stand in opposition of issues to do with market efficiency without facts of their own proving. The winner-loser results were due to “market overreaction to extreme bad or good news about firms”.

Due to conceptual complexity, it is indeed very difficult to decide which explanation about greatest winners and losers is correct as far as return behavior is concerned, but, the factual layout by DeBondt and Thaler and their critics are rather interesting (Milionis, 2006).

Conclusion

In conclusion, Fama's 1970 work capitalized on forecasting returns - for short horizons - from past returns and present research considers variables such as dividend yields (D/P), earnings per price ratios (E/P), and term-structure variables when assessing the predictability of returns for longer horizons. Short-horizon returns are predicted on daily, weekly, and monthly bases while long-term horizons are determined for periods exceeding 12 months.

Despite the narrow cracks in Fama's work, his concept about return predictability is still being used by economists, financial analysts, and market projection professionals to protect business personalities from "investment shocks". Prior to starting a business or buying and/or selling stock, it is imperative to assess the profitability of your financial efforts. In the modern business platform, the concept of market efficiency is used on a global scale. Business persons utilize market efficiency science to know what they are really landing their feet on. Nobody wants to miss returns on investment or any good business prospect, thus, Fama can be considered as a hero of modern analysis of market dynamics.

The critics of Fama's work also deserve credit for their bold evaluation of NYSE return results. They introduced an extra dimension to the determination of market efficiency. Now investors can know the quantity and time of returns using the concept of efficient capital markets.

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