Assignment 3 (Solution)

Financial Investment
Autumn 2023

1. In an efficient market, the change in a company's share price is most likely the result of:
    a) Insiders' private information.
    b) The previous day's change in stock price.
    c) New information coming into the market.

Today's price change is independent of the one from yesterday, and in an efficient market, investors will react to new, independent information as it is made public.

2. Regulation that restricts some investors from participating in a market will most likely:
    a) Impede market efficiency.
    b) Not affect market efficiency.
    c) Contribute to market efficiency.

Reducing the number of market participants can accentuate market imperfections and impede market efficiency (e.g., restrictions on foreign investor trading).

3. Which of the following regulations will most likely contribute to market efficiency? Regulatory restrictions on:
    a) Short selling.
    b) Foreign traders.
    c) Insiders trading with nonpublic information.

Regulation to restrict unfair use of nonpublic information encourages greater participation in the market, which increases market efficiency. Regulators (e.g., U.S. SEC) discourage illegal insider trading by issuing penalties to violators of their insider trading rules.

4. Which of the following market regulations will most likely impede market efficiency?
    a) Restricting traders' ability to short sell.
    b) Allowing unrestricted foreign investor trading.
    c) Penalizing investors who trade with nonpublic information.

Restricting short selling will reduce arbitrage trading, which promotes market efficiency. By contrast, allowing unrestricted foreign investor trading increases market participation, which makes markets more efficient. Furthermore, penalizing insider trading encourages greater market participation, which increases market efficiency.

5. If markets are efficient, the difference between the intrinsic value and market value of a company's security is:
    a) Negative.
    b) Zero.
    c) Positive.

A security's intrinsic value and market value should be equal when markets are efficient.

6. The intrinsic value of an undervalued asset is:
    a) Less than the asset's market value.
    b) Greater than the asset's market value.
    c) The value at which the asset can currently be bought or sold.

The intrinsic value of an undervalued asset is greater than the market value of the asset, where the market value is the transaction price at which an asset can be currently bought or sold

7. The market value of an undervalued asset is:
    a) Greater than the asset's intrinsic value.
    b) The value at which the asset can currently be bought or sold.
    c) Equal to the present value of all the asset's expected cash flows.

The market value is the transaction price at which an asset can be currently bought or sold.

8. With respect to the efficient market hypothesis, if security prices reflect only past prices and trading volume information, then the market is:
    a) Weak-form efficient.
    b) Strong-form efficient.
    c) Semistrong-form efficient.

The weak-form efficient market hypothesis is defined as a market where security prices fully reflect all market data, which refers to all past price and trading volume information.

9. Which one of the following statements best describes the semistrong form of market efficiency?
    a) Empirical tests examine the historical patterns in security prices.
    b) Security prices reflect all publicly known and available information.
    c) Semistrong-form efficient markets are not necessarily weak-form efficient.

In semistrong-form efficient markets, security prices reflect all publicly available information.

10. If markets are semistrong efficient, standard fundamental analysis will yield abnormal trading profits that are:
    a) Negative.
    b) Equal to zero.
    c) Positive.

If all public information should already be reflected in the market price, then the abnormal trading profit will be equal to zero when fundamental analysis is used.

11. If prices reflect all public and private information, the market is best described as:
    a) Weak-form efficient.
    b) Strong-form efficient.
    c) Semistrong-form efficient.

The strong-form efficient market hypothesis assumes all information, public or private, has already been reflected in the prices.

12. If markets are semistrong-form efficient, then passive portfolio management strategies are most likely to:
    a) Earn abnormal returns.
    b) Outperform active trading strategies.
    c) Underperform active trading strategies.

Costs associated with active trading strategies would be difficult to recover; thus, such active trading strategies would have difficulty outperforming passive strategies on a consistent after-cost basis.

13. If a market is semistrong-form efficient, the risk-adjusted returns of a passively managed portfolio relative to an actively managed portfolio are most likely:
    a) Lower.
    b) Higher.
    c) The same.

In a semistrong-form efficient market, passive portfolio strategies should outperform active portfolio strategies on a risk-adjusted basis.

14. Technical analysts assume that markets are:
    a) Weak-form efficient.
    b) Weak-form inefficient.
    c) Semistrong-form efficient.

Technical analysts use past prices and volume to predict future prices, which is inconsistent with the weakest form of market efficiency (i.e., weak-form market efficiency). Weak-form market efficiency states that investors cannot earn abnormal returns by trading on the basis of past trends in price and volume.

15. Fundamental analysts assume that markets are:
    a) Weak-form inefficient.
    b) Semistrong-form efficient.
    c) Semistrong-form inefficient.

    Fundamental analysts use publicly available information to estimate a security's intrinsic value to determine if the security is mispriced, which is inconsistent with the semistrong form of market efficiency. Semistrong-form market efficiency states that investors cannot earn abnormal returns by trading based on publicly available information.