- Chapter 4 – Efficient Securities Markets

Why do we care about the functioning of markets?

- Social welfare is enhanced if scarce capital is allocated to the most productive alternatives
- Investors need protection

Definition of Market Efficiency

Efficiency in the following form:	*Implies that prices properly reflect:*
Weak	Information about past sequences of prices
Semi-strong	All publicly available information, including f/s
Strong	All information, including insider information

Market Efficiency

- As we move away from ideal conditions:
  - no publicly observable states, so information is not free
  - no complete sets of states of nature and their probabilities, so information is subjective

- Under these conditions, can you have an efficient market?
  - Prior beliefs of individual investors tend to average out, so that the market price has superior quality on average to the quality of the information processing of the individuals trading on the market.

Chapter 4

- Question 1 – In class discussion

Chapter 4

- Question 4 – In class discussion

Chapter 4

The IASB/FASB Framework (Section 3.7.1) includes comparability as an enhancing characteristic of financial information. If securities markets are efficient, give an argument why lack of comparability of a firm's accounting policies with other firms should not affect its share price. Give an argument why its share price may be affected by lack of comparability.

Chapter 4

You have just obtained inside information about a firm that employs you and in which you own shares. The information is that the current quarter's earnings will be substantially below forecast. Should you sell your shares before the bad news becomes publicly known? Outline arguments for and against this temptation.

Diversification

- In a diversified portfolio, the firm specific risk of the individual securities tends to cancel each other out, leaving just the systematic (market-wide) risk. Therefore, if an investor adds a security to a well diversified portfolio, nearly all the new risk is related to the systematic risk only (which is captured by beta)

- The market prices securities in such a way that the expected return is commensurate with the risk. Since firm-specific risk can be diversified away, the market will not "reward" for that risk.

Market Efficiency

- Evidence suggests that the market is efficient in the ***semi-strong*** form:
  - on average, publicly available information is properly reflected in security prices.
  - Expected abnormal returns are unbiased and random.
  - the market is not fooled by "cosmetics": as long as accounting policies have no differential cash flow effects (eg. taxes, time value of money), the policies are disclosed and sufficient information is given, readers can convert.
  - the market reacts quickly to new, relevant, unexpected information.
  - you cannot systematically beat the market by analyzing publicly available information

Market Efficiency

- Then, does price become fully informative? How does this protect the naive investor?
  - Prices that are fully informative create an unstable equilibrium (impossibility of informationally efficient markets).
  - Prices that are partially informative (ie. due to *some* trades being driven by rationally informed investors) create a continuing demand and role for information as investors

Summary: to work properly…

- Markets will operate to ensure that scarce capital is allocated to the most productive alternatives -and-
- Individual investors will be protected

Summary: how is this achieved?

- The market processes this information efficiently -and-
- All relevant information is in the public domain

Implications for accountants

1. Don’t need to argue about “cosmetic” accounting policy choices as long as all info is disclosed to allow readers to convert
2. Full disclosure is important (subject to cost)
3. Not necessary to be overly concerned with naïve investors
4. Accounting is only one source of information available to the market. It will be valuable only if it is a relevant, reliable, timely and cost-effective vehicle of communication.

Information Asymmetry

- When we discuss market efficiency, we refer to "publicly available" information. This leads us to an important concept in accounting theory, "information asymmetry"
- Recall from Chapter 1, there are two types of information asymmetry …
- These two types of information asymmetry create additional source of estimation risk for the investor. Reaction to incr. risk: bidding down the price of securities, assigning less value